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**The Basel Accords as a Transnational Regulatory Law  
A Focus on Regulatory Consistency and Domestic Embeddedness**

Bugeja, George Carmel

*Awarding institution:*  
King's College London

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# **The Basel Accords as a Transnational Regulatory Law: A Focus on Regulatory Consistency and Domestic Embeddedness**

*Thesis submitted to King's College London in accordance with the requirement for the  
degree of Doctor of Philosophy (PhD) in Law*

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**Date:** August 2018

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## Abstract

This thesis argues that the Basel Accords have been stretched beyond their original scope, which was to promote regulatory convergence amongst internationally-active banks. It is here argued that the current form of the Basel Accords, having been promulgated as a transnational regulatory law by the Basel Committee on Banking Supervision, is not appropriate in order to have an effective transnational regulatory standard. The change in scope of the Basel Accords along the years has resulted in various recursive cycles such that one cannot argue that these standards have since “settled”.

Whilst the Basel Accords are generally considered as the main regulatory standard for banks (by national regulatory authorities and the industry), different jurisdictions have applied these standards to different types of entities, giving rise to regulatory arbitrage opportunities. Furthermore, certain jurisdictions may have incentives to allow for regulatory arbitrage opportunities as this may allow them to be more competitive than other jurisdictions.

This thesis continues by arguing that whilst the Basel Accords seek to provide regulation to cater for risks which banks have, the said Basel Accords ignore the fact that banks in different jurisdictions may be subject to varying levels of risk depending on whether these banks operate in pro-creditor or pro-debtor jurisdictions<sup>1</sup>.

This thesis refers to the Cape Town Convention and argues that this can be used as a model to have a transnational law on banking standards which will be able to overcome these issues.

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<sup>1</sup> Wood Philip R., *Regulation of International Finance* in “The Law and Practice of International Finance Series” (Sweet and Maxwell, Vol. 7, 2007) 663 – 664.

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This thesis is dedicated to my grandfather, Carmel, who passed away in April 2018, and who was always a source of inspiration to me throughout my endeavours.

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*George C Bugeja*

*London, August 2018*



## List of acronyms and abbreviations

|        |  |
|--------|--|
| AIF    | Alternative Investment Fund                                  |
| AIFM   | Alternative Investment Fund Manager                          |
| AIFMD  | Alternative Investment Fund Managers Directive               |
| ASU    | Sector Understanding on Export Credits for Civil Aircraft    |
| BCBS   | Basel Committee on Banking Supervision                       |
| BIS    | Bank for International Settlements                           |
| BREXIT | The process through which the UK will withdraw from the EU   |
| BRIC   | Brazil, Russia, India, China                                 |
| CRD IV | Capital Requirements Directive IV                            |
| CRD V  | Capital Requirements Directive V                             |
| CRR    | Capital Requirements Regulation                              |
| CRR II | Capital Requirements Regulation II                           |
| CTC    | Convention on International Interests in Mobile Equipment    |
| EBA    | European Banking Authority                                   |
| ECA    | Export Credit Agency   |
| ECB    | European Central Bank  |
| EU     | European Union   |
| FDIC   | Federal Deposit Insurance Corporation                        |
| FIDIC  | International Federation of Consulting Engineers             |
| FSB    | Financial Stability Board                                    |
| G-SIB  | Global Systemically Important Bank                           |
| ICAO   | International Civil Aviation Organization                    |
| IDERA  | Irrevocable De-Registration and Export Request Authorisation |

|          |   |
|----------|---|
| IMF      | International Monetary Fund                                       |
| IOSCO    | International Organization for Securities Commissions             |
| IRB      | Internal Ratings-Based  |
| ISDA     | International Swaps and Derivatives Association                   |
| MiFID    | Markets in Financial Instruments Directive                        |
| MiFID II | Markets in Financial Instruments Directive II                     |
| MPR      | Minimum Premium Rate  |
| OECD     | Organisation for Economic Co-operation and Development            |
| PRA      | Prudential Regulation Authority                                   |
| SEC      | Securities and Exchange Commission                                |
| UCC      | Uniform Commercial Code   |
| UCITS    | Undertakings for Collective Investment in Transferable Securities |
| UK       | United Kingdom  |
| UNCITRAL | United Nations Commission on International Trade Law              |
| UNIDROIT | International Institute for the Unification of Private Law        |
| US       | United States of America  |
| USD      | United States Dollar  |
| WTO      | World Trade Organisation  |

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*United Dominions Trust Ltd v. Kirkwood* [1966] 2 Q.B. 431

### **United States of America**

*Oulton v. German Savings and Loan Society* 84 US (17 Wall) 109 (1873)

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## **Brazil**

Law No. 4,595 dated December 31, 1964, on the National Financial System

## **Canada**

Civil Code of Quebec

Personal Property Security Act

## **European Union**

### **Regulations**

Council regulation (EC) No 1346/2000 on insolvency proceedings [2000] OJ L 160/1

Regulation (EC) No 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations [2008] OJ L 177

Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance [2013] OJ L 176/1

Regulation (EU) 2015/848 of the European Union and of the Council of on insolvency proceedings (recast) [2015] OJ L 141

### **Directives**

First Council Directive 77/780/EEC on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [1977] OJ L 322/30

Council Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions [1993] OJ L 141

Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L 145

Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L 177

Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L 174/1

Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance [2013] OJ L 176/338

Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L 173

Directive 2015/2366/EU of the European Parliament and of the Council on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC [2015] OJ L 337

### **Commission Recommendations**

Commission Recommendation C(2014) 1500 final on a new approach to business failure and insolvency [2014]

## **France**

Loi no. 2013-672 du 26 juillet 2013 de Séparation et de Régulation des Activités Bancaires  
(Law on the Separation and Regulation of Banking Activities)

## **International Conventions and Protocols**

### **Conventions**

Convention on International Interests in Mobile Equipment (Cape Town, November 2001)

Convention on the International Recognition of Rights in Aircraft (Geneva, 1948)

UNIDROIT Convention on International Factoring (Ottawa, 1988)

UNIDROIT Convention on International Financial Leasing (Ottawa, 1988)

United Nations Convention on the Assignment of Receivables in International Trade (New York, 2001)

Vienna Convention on the Law of Treaties (Vienna, 1969)

## **Protocols**

Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Cape Town, November 2001)

Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock (Luxembourg, February 2007)

Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets (Berlin, March 2012)

## **Netherlands**

Civil Code

## **Switzerland**

Ordonnance sur les fonds propres et la répartition des risques des banques et des négociants en valeurs mobilières  
(Capital Adequacy Ordinance)

## **United Kingdom**

Financial Services (Banking Reform) Act 2013

## **United States of America**

Bankruptcy Code

Dodd-Frank Wall Street Reform and Consumer Protection Act

## **Preamble: A Note on “*BREXIT*”**

On the 29 March 2017 the United Kingdom (“**UK**”) formally commenced the process of withdrawing from the European Union (“**EU**”) in accordance with Article 50 of the Treaty on European Union (with this process being referred to as “**BREXIT**”), meaning that the UK will be withdrawing from the EU on the 29 March 2019.

While it seems that there will be no immediate and apparent effects of BREXIT on the contents of this thesis, the long-term effects will most probably continue to enhance the arguments made throughout this thesis.

The main problems discussed below arise due to a lack of regulatory convergence across different jurisdictions, and also as a result of a lack of harmonisation of laws on security interests and insolvency. Over the past years the EU has sought to have further regulatory convergence amongst its member states, and the problem of regulatory arbitrage within EU member states has been reduced and will continue to be minimised as further regulatory convergence takes place.

As the UK withdraws from the EU, however, the probability will be that UK laws will not continue to be fully harmonised with EU laws, and the UK will possibly continue to develop as a very important actor in the Basel Accords’ process, acting out of self-interest, and competing with other jurisdictions or economic groupings (including the EU). As differences continue to arise from the way in which the Basel Accords and other national laws are implemented, the possibility for regulatory arbitrage may continue to grow, thereby impeding the Basel Accords from reaching their aims.

## **PART I – INTRODUCTION**



# Chapter 1: Introduction

## 1.1 Research Problem

Though states adopt different approaches to law, have varying linguistic styles, and have dissimilar legal and non-legal backgrounds, they nevertheless seek to work together where this can result in positive benefits for all. Transnational law has therefore emerged as a way through which common solutions are sought for common problems which are best dealt with by having different jurisdictions adopting similar laws or regulations. As legal systems develop and as different jurisdictions work together, this gives rise to a common understanding, allowing legislative texts and regulatory standards to have greater maturity and effectiveness, thereby drawing variances across different jurisdictions closer to each other.

Throughout the years the Basel Committee on Banking Supervision (“**BCBS**”) has tried to bring different banking regulators and supervisory authorities together and has sought to allow these different regulators and authorities to understand each other better and adopt similar regulatory standards. However, though similar terms are today used by different national regulators, it will here be argued that there is yet to be a common understanding of what these same terms refer to<sup>2</sup>. Furthermore it will be argued that in light of major differences across different jurisdictions other fundamental questions (such as what type of capital adequacy laws shadow banks should have, or whether any consideration should be given to the type of insolvency laws which a jurisdiction adopts), are discarded and not given any particular weight by the Basel Accords, notwithstanding the varying levels of risk which different states may be subject to as a result of these matters.

It is proposed that the Basel Accords are yet to mature to a sufficient extent and are yet to reach a level of harmonisation and acceptance across jurisdictions which can lead to these international standards reaching their full potential. The Basel Accords thus can be seen as a victim of their own success: though they can be considered to be very successful and effective for what they originally set out to be (and when considering that their initial regulatory scope was limited to “*internationally-active banks*”), the Basel Accords are now viewed as the main regulatory standard for regulation of all banks

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<sup>2</sup> By way of example, and as will be discussed later on in this thesis, though the Basel Accords originally set out to regulate “*internationally-active banks*”, there is to-date no common understanding as to what the term “*bank*” refers to, or what the term “*internationally-active*” should encompass.

around the world. It is argued, however, that the framework on which the Basel Accords are based is too limited, such that it cannot be used as an effective regulatory standard for the regulation of all banks.

This thesis will focus on the Basel Accords as constituting a form of “*transnational regulatory law*”. This term will be analysed in further detail in Chapter 2, and it will be distinguished from the more generic term of “*transnational law*”. For the purpose of this introduction, however, it suffices to say that the Basel Accords are a form of “*regulation*”, and for this purpose various concepts which have been used in analysing the role of “*regulation*” have been applied to the Basel Accords. The regulation which is adopted here is however “*transnational*” in nature given that regulatory bodies which have promulgated these international standards do not act alone within a national framework, but have come together through transnational regulatory networks (and through the BCBS) in order to have one set of regulatory standards which are (supposedly) applied in the same way across borders.

The main purpose of the BCBS (which is the transnational regulatory network which has promulgated the Basel Accords, and which includes national organisations with direct banking supervisory authority and central banks<sup>3</sup>) has been outlined in the Basel Committee Charter which establishes the BCBS, which states as follows:

### **1. Mandate**

*The BCBS is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability<sup>4</sup>.*

The BCBS thus provides a forum in which different supervisory authorities and central banks come together in order to discuss prudential regulation of banks. However, despite the good intentions of the BCBS, the Basel Accords have only been written by bankers for bankers, and there has been a lack of a proper legal (and economic) analysis of the effects of the prudential regulation established by these Accords.

This thesis does not seek to adopt a banking, financial or accounting approach to these international standards. Rather it seeks to look at the Basel Accords from a legal

---

<sup>3</sup> Bank for International Settlements, ‘Basel Committee Charter’ (Updated 30 December 2016) <[https://www.bis.org/bcbs/charter.htm#purpose\\_role](https://www.bis.org/bcbs/charter.htm#purpose_role)> accessed 11 February 2017.

<sup>4</sup> *ibid.*

perspective in order to highlight major problems which the current drafting of the Basel Accords gives rise to. It will be argued that the Basel Accords ignore fundamental differences across jurisdictions leading to a lack of regulatory consistency, and giving rise to regulatory arbitrage possibilities. Furthermore, financing parties established in different jurisdictions are subject to different levels of risk in light of domestic laws within which the Basel Accords operate. The Convention on International Interests in Mobile Equipment (the “CTC” or the “**Cape Town Convention**”) is thus presented as an illustration of the limitations of the Basel Accords, and it will be argued that the Basel Accords should use the CTC as a model through which the limitations highlighted by this thesis are reduced significantly.

## ***1.2 Purpose of the Research and its Contribution to Existing Literature***

This thesis seeks to analyse the main concepts behind the Basel Accords from a legal perspective. This approach seeks to contribute to existing literature in that the Basel Accords have been mainly analysed from a banking and finance perspective. The Basel Accords regularly are described as a typical example of a “*transnational law*” or of a “*transnational regulatory law*”, yet the underlying assumptions behind this term (and the features which make the Basel Accords a transnational law or a transnational regulatory law) are not probed.

Concepts from law and economics are also referred to in order to question whether the relevant actors have incentives to adopt, implement and enforce the Basel Accords in a consistent manner across jurisdictions. For this purpose, the CTC is presented as an example of a transnational law which made use of economic analysis when this was being drafted<sup>5</sup>, given that this can be used as a model through which the problems mentioned throughout this thesis can be addressed by the drafters of the Basel Accords.

The Basel Accords set out international standards for national regulatory bodies to adopt, and monitoring programmes have been implemented in order to ensure that the said standards are properly adopted across different jurisdictions. However, the Basel Accords have been drafted by adopting a “*one-size-fits-all*” approach, and in the absence of any analysis as to whether different jurisdictions adopt different banking models;

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<sup>5</sup> Jeffrey Wool, *Treaty Design, Implementation, and Compliance Benchmarking Economic Benefit – a Framework as Applied to the Cape Town Convention* (Uniform Law Journal, Issue 4, 2012) 633 (Wool 2012); Jeffrey Wool, *Economic Analysis and Harmonised Modernisation of Private Law* (Uniform Law Review, Vol 8, 2003-1/2, UNIDROIT, 2003) 389 (Wool 2003).

what the interests of states and of the industry are in different jurisdictions; and whether financing parties are subject to varying risks depending on the jurisdictions where they provide their services or otherwise. This has recently been acknowledged by the European Parliament, which whilst noting that different jurisdictions adopt varying banking systems<sup>6</sup>, has recognised that a “one-size-fits-all” approach by the Basel Accords may be “*ineffective and disproportionately burdensome, in particular for many smaller, domestically focused, less complex and interconnected banks, as well as their regulators and supervisors*”<sup>7</sup>.

This thesis therefore seeks to advance literature by undertaking an analysis of the differences in the types of entities to which the Basel Accords have been extended across different jurisdictions; applying certain economic concepts to the Basel Accords; and challenging the assumption that all entities to which the Basel Accords apply are subject to the same level of risk. This is done in order to argue that risks which the Basel Accords sought to reduce may still be present notwithstanding the adoption of the Basel Accords in different jurisdictions.

### **1.3 Research Methodology**

This thesis has reviewed relevant literature, and applied concepts from a number of different fields of law to the Basel Accords. Consequently, it does not set out to provide a description of the contents of the Basel Accords<sup>8</sup>, but focuses on specific aspects of relevance to this thesis in order to analyse whether the underlying framework of the Basel Accords is appropriate for it to reach its stated aims and be applied consistently across different jurisdictions.

Literature from transnational law and transnational regulatory law has been reviewed in order to be able to frame the Basel Accords in their correct setting and see what the main influences are in having a functioning transnational regulatory law. This has primarily been done by considering authoritative authors on this subject-matter and

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<sup>6</sup> See by way of example: European Parliament, *Basel III Revision: MEPs Want to Ensure the EU Banking Model is not Penalised* (Press Release, 10 November 2016) <[http://www.europarl.europa.eu/pdfs/news/expert/infopress/20161108IPR50512/20161108IPR50512\\_en.pdf](http://www.europarl.europa.eu/pdfs/news/expert/infopress/20161108IPR50512/20161108IPR50512_en.pdf)> accessed 16 April 2017.

<sup>7</sup> European Parliament, *European Parliament Resolution of 23 November 2016 on the Finalisation of Basel III* (2016/2959(RSP) Recital H <<http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0439+0+DOC+PDF+V0//EN>> accessed 20 April 2017.

<sup>8</sup> As a result this thesis does not set out to describe the three pillars of the Basel Accords, how regulatory capital is calculated, the liquidity requirements, and the leverage restrictions established by the Basel Accords.

applying key principles referred to by these authors to the Basel Accords. In particular, this thesis has adopted Zumbansen's methodological approach<sup>9</sup> of considering the main actors, norms and processes in relation to the Basel Accords and as a result of which the Basel Accords have been promulgated and adopted throughout the years. Authors such as Verdier<sup>10</sup> and Avgouleas<sup>11</sup> are also referred to when considering how the Basel Accords, as a transnational regulatory law operating through managed networks, make use of "soft-law" and the implications which this has on the way in which the Basel Accords are adopted and enforced across different jurisdictions. Furthermore, Halliday's<sup>12</sup> recursivity theory is considered as a basis for the argument that the Basel Accords are still undergoing iterative cycles, and consequently are yet to be settled.

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<sup>9</sup> Peer Zumbansen, *Transnational Law, Evolving* (Comparative Research in Law & Political Economy, Research Paper No 27/2011, 2011) <<http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1065&context=clpe>> accessed 10 January 2015; Peer Zumbansen, *Defining the Space of Transnational Law: Legal Theory, Global Governance, and Legal Pluralism* (Transnational Law & Contemporary Problems, Vol 21, Summer 2012) <[http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1758&context=scholarly\\_works](http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1758&context=scholarly_works)> accessed 12 December 2016 (Zumbansen 2012); Peer Zumbansen, *Lochner Disembedded: The Anxieties of Law in a Global Context* (Indiana Journal of Global Legal Studies, Volume 20, Issue 1, 2013) <<https://muse.jhu.edu/article/520149>> accessed 23 January 2017 (Zumbansen 2013); Peer Zumbansen, *Where the Wild Things Are: Journeys to Transnational Legal Orders, and Back* (King's College London Dickson Poon School of Law, Legal Studies Research Paper Series: Paper No 2016-11) <<https://ssrn.com/abstract=2723990>> accessed 12 December 2016 (Zumbansen 2016).

<sup>10</sup> Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits* (Yale J.Int'l L., Vol. 34, 2009) (Verdier 2009); Pierre-Hugues Verdier, 'US Implementation of Basel II: Lessons for Informal International Lawmaking' in Joost Pauwelyn, Ramses Wessel & Jan Wouters (eds), *Informal International Lawmaking* (OUP, 2012) <[https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=1879391](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=1879391)> accessed 1 February 2017 (Verdier 2012).

<sup>11</sup> Emiliós Avgouleas, *Rationales and Designs to Implement an Institutional Big Bang in the Governance of Global Finance* (Seattle University Law Review, Vol. 36, 2013).

<sup>12</sup> Terence C. Halliday and Gregory Shaffer, 'Researching Transnational Legal Orders' in Terence C. Halliday and Gregory Shaffer (eds.) *Transnational Legal Orders* (Cambridge University Press, 2015) 475; Terence C. Halliday and Gregory Shaffer, 'Introduction' in Terence C. Halliday and Gregory Shaffer (eds.) *Transnational Legal Orders* (Cambridge University Press, 2015) 3 (Halliday and Shaffer Introduction); Terence C Halliday and Bruce G Carruthers, *The Recursivity of Law: Global Norm Making and National Lawmaking in the Globalization of Corporate Insolvency Regimes* (American Journal of Sociology, Vol 112 No 4, January 2007) <[http://www.jstor.org/stable/10.1086/507855?seq=1#page\\_scan\\_tab\\_contents](http://www.jstor.org/stable/10.1086/507855?seq=1#page_scan_tab_contents)> accessed 12 December 2016; Terence C Halliday, *Recursivity of Global Normmaking: A Sociolegal Agenda* (Annual Review of Law and Social Science, 2009, Vol 5) 263 <<http://www.annualreviews.org/doi/pdf/10.1146/annurev.lawsocsci.093008.131606>> accessed 12 December 2016; Susan Block-Lieb and Terence C. Halliday, 'Settling and

A comparative analysis of relevant banking laws and financial regulation of the UK, the wider EU and the United States of America (“US”) has also been undertaken in order to understand what the different terminology referred to throughout the Basel Accords means in different jurisdictions. Relatedly, laws implementing the Basel Accords in different jurisdictions (particularly the EU and the US) have also been referred to in order to understand the diverse ways in which the Basel Accords have been implemented in different jurisdictions. The comparative analyses carried out in this regard consider both primary texts as well as secondary texts (including analyses done by the BCBS particularly when carrying out its Regulatory Consistency Assessment Programme<sup>13</sup>).

On considering the varying interests which the main actors have in relation to the Basel Accords, reference has been made to concepts deriving from law and economics by referring to authors such as Cooter<sup>14</sup>. This has been done in order to understand what impact the Basel Accords have on different players, and what sort of rational approach each of these actors would take on seeking to maximise their own utility.

This thesis also considers varying laws on insolvency and laws which reduce credit risk in different jurisdictions. This analysis particularly considers the work of Wood<sup>15</sup> who has sought to classify jurisdictions according to their pro-creditor or pro-debtor approach to law. The varying positions adopted by different jurisdictions have been analysed in order to show that certain jurisdictions are much more pro-creditor than other pro-debtor jurisdictions, and in order to argue that a “one-size-fits-all” approach to

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Concordance: Two Cases in Global Commercial Law’ in Terence C. Halliday and Gregory Shaffer (eds.) *Transnational Legal Orders* (Cambridge University Press, 2015) 75.

<sup>13</sup> Bank for International Settlements, ‘RCAP: Role, Remit and Methodology’ <[https://www.bis.org/bcbs/implementation/rcap\\_role.htm](https://www.bis.org/bcbs/implementation/rcap_role.htm)> accessed 14 June 2015.

<sup>14</sup> Robert Cooter, *Expressive Law and Economics* (January 1998) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=111408](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=111408)> accessed 24 January 2016; Robert Cooter, *Law and Unified Social Theory* (Journal of Law and Society, Vol. 22, No. 1, Socio-Legal Studies, March 1995) 50 (Cooter 1995); Robert Cooter and Jody S Kraus, *The Measure of Law and Economics* (August 2014) <[http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1005&context=law\\_econ](http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1005&context=law_econ)> accessed 25 March 2016.

<sup>15</sup> Wood (n 1); Philip R Wood, *Principles of International Insolvency (Part I)* (International Insolvency Review, Vol. 4, Issue 1, 1995) 94 (Wood 1995(I)); Philip R Wood, *How to Compare Regulatory Regimes* (Capital Markets Law Journal, Vol. 2, No. 4, 2007) 332 (Wood 2007); Philip R Wood, *Predictions for the Future of Financial Law and Lawyers* (Business Law International, Vol. 9, No. 3, September 2008) 234 (Wood 2008); Philip R Wood, *Principles of International Insolvency (Part II)* (International Insolvency Review, Vol 4, Issue 2, 1995) 109 (Wood 1995(II)).

the Basel Accords is not appropriate in light of the varying risks which may arise on financing entities, depending on the jurisdictions within which they operate.

## **1.4 Chapter Outline**

Following this introduction, Chapter 2 will consider the main elements of the Basel Accords as a form of transnational regulatory law. Distinctions will be drawn between transnational laws and transnational regulatory laws, and the thesis will also continue by considering the recursive cycles which have taken place in relation to the Basel Accords throughout the years.

Chapter 3 will analyse the entities which the Basel Accords sought to regulate and the objectives which the Basel Accords had set out to achieve. It will be shown that whilst the Basel Accords sought to regulate “*internationally-active banks*”, there is no definition as to what makes a bank “*internationally-active*”, and there neither is a definition as to what constitutes a “*bank*”. Thus, whilst the Basel Accords have become the global standard for regulation of banks in general (and not just internationally-active banks), the lack of definitions has given rise to possibilities of regulatory arbitrage as different states have sought to apply the Basel Accords to different types of entities. It also will be shown that throughout the years the regulatory objective of the Basel Accords has changed from that of achieving regulatory convergence, towards that of seeking to have global financial stability.

Chapter 4 will argue that it is essential for the main actors to be involved in the adoption, implementation, functioning and enforcement of the Basel Accords in order to ensure the proper functioning of the Basel Accords, particularly in light of the different interests and incentives which different actors may have. For this purpose this thesis will take insights from law and economics literature. It will here consider the main actors as being: the individual regulators from different states coming together in one international community; individual states acting alone on implementing and enforcing the Basel Accords at a national level; and the industry.

The thesis will argue that the Basel Accords also lack legitimacy and accountability, with this being the result of the promoters of the Basel Accords failing to consider the interests of states (acting individually and considering their own self-interest rather than the interests of the international community) and of the industry. Chapter 5 will demonstrate that the lack of consideration of the interests of the individual states and of the industry has given rise to regulatory arbitrage opportunities.

Chapter 6 will highlight important distinctions amongst different jurisdictions such that certain jurisdictions are considered to be much more pro-creditor than others, particularly in light of the differences in the laws on insolvency and on security interests of these jurisdictions. Chapter 7 will seek to consider different techniques through which credit risk can be mitigated, and will continue by arguing that notwithstanding that the Basel Accords have sought to regulate banks in order to cater for the risks which they face, banks in different jurisdictions are subject to different levels of risk, depending on the jurisdictions within which they operate. The thesis will therefore show that notwithstanding that there is one transnational regulatory law which seeks to establish the required capital adequacy limits which banks should hold as a buffer for the risks they face, the capital adequacy levels do not distinguish between the states in which the banks operate, and this notwithstanding that banks operating in pro-debtor jurisdictions are necessarily subject to higher risks than banks operating in pro-creditor jurisdictions.

Chapter 8 will outline the main elements of the CTC<sup>16</sup> and it will suggest that the CTC has been successful in dealing with each of the main problems discussed throughout this thesis. Chapter 9 will conclude this thesis by making three proposals which seek to address the main problems discussed throughout the thesis, as follows:

- It will be argued that the soft-law approach adopted by the Basel Accords should be supported by a binding text which will create legal rights and obligations under an international law framework, and which will also be able to provide clarity to inconsistencies which are highlighted by this thesis (including to which entities the Basel Accords should apply).
- Once binding principles are agreed to, different jurisdictions should be allowed to interpret the Basel Accords freely and allow for regulatory competition within the framework of the binding principles which would have been agreed to. This will ensure that national regulators take responsibility for the regulations which they adopt, whilst also giving flexibility to regulators to act when it becomes clear that risks increase as a result of regulatory arbitrage. This would also allow regulators to reduce unnecessary social costs which the current framework seemingly encourages.
- It will be argued that model laws on insolvency and security interests should also be promulgated, and with the Basel Accords being used to encourage states to

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<sup>16</sup> Convention on International Interests in Mobile Equipment (Cape Town, November 2001) (Cape Town Convention or CTC).



reduce risks to financing entities by providing a favourable regime for those financing entities operating in pro-creditor jurisdictions.

## **PART II – THE BASEL ACCORDS AND TRANSNATIONAL LAW**

## Chapter 2: The Basel Accords as a Transnational Regulatory Law

### 2.1 *The Basel Accords and Transnational Law*

The Basel Accords seek to regulate actions and actors which transcend national frontiers, and can therefore be classified as one of the typical examples of “*transnational law*” (or more specifically “*transnational regulation*”)<sup>17</sup>. In light of increased globalisation, actors from different states have come together to regulate the banking industry, and these international standards have now been adopted by most states around the world. Following the financial crisis, the Basel Accords have been even more focused towards the adoption of a macroprudential approach to regulation (particularly when seeking to focus on the reduction of systemic risks across the globe), thus rendering the Basel Accords, and their implementation, enforcement and supervision even “*more transnational*” in nature<sup>18</sup>.

This Chapter will commence by giving a brief background to the Basel Accords. The main features of transnational law (and more specifically transnational regulatory law) will then be analysed such that this Chapter will also consider different decision-making structures which may be used in promulgating, implementing and enforcing transnational laws and regulations. This thesis will argue (in Chapter 9) that there needs to be a shift towards further regulatory competition in order to allow the Basel Accords to reach their current aims.

This Chapter will also consider different influences to which transnational regulation and the national bodies which seek to implement it are subject, and which may limit the effectiveness of transnational regulatory laws such as the Basel Accords. The recursive

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<sup>17</sup> Eleni Tsingou, ‘Transnational Governance Networks in the Regulation of Finance’ in Morten Ougaard and Anna Leander (eds), *Business and Global Governance* (Routledge, 2010) 139; Emiliios Avgouleas, *The Reform of ‘Too-Big-To-Fail’ Bank – A New Regulatory Model for the Institutional Separation of ‘Casino’ from ‘Utility’ Banking* (February 2010) 11 <<http://ssrn.com/abstract=1552970>> accessed 8 December 2014; Zumbansen (n 9) 3; For the purposes of this thesis one needs to keep in mind the special status of the European Union as a regional grouping within which further internal harmonisation has also been carried out. Therefore throughout discussions relating to the development of transnational laws and transnational regulatory laws, the European Union may at times need to be considered as one ‘State’ acting in an international market. Furthermore, where no unification or approximation of laws or regulations would have taken place within the EU, separate Member States will need to be considered individually as separate States.

<sup>18</sup> Andrew Baker, ‘Macroprudential Regulation’ in Daniel Mügge (ed), *Europe and the Governance of Global Finance* (Oxford University Press, 2014) 174 – 176.

processes which the Basel Accords have undergone throughout the years, and the extent to which one can argue that the Basel Accords have “settled” will also be considered in order to support the argument that the Basel Accords cannot be considered to have “settled” as yet.

### **2.1.1 Background to the Basel Accords**

The main rationale behind capital adequacy regulation is that higher capital ratios lead to safer banks<sup>19</sup>. Capital adequacy methodologies have long been considered as necessary regulatory tools to ensure that both abnormal claims on bank deposits as well as unexpected losses could be catered for. Capital thus serves as a buffer against abnormal claims or unexpected losses, whilst also keeping the public’s confidence in banks high (with this being particularly important since banks can never immediately repay all deposits held with them to their customers, in light of the maturity transformation function which they carry out, making them particularly exposed to bank runs on a loss of confidence by the public)<sup>20</sup>.

It has also been argued that, in the absence of regulatory requirements, banks would tend to combine low capital ratios with a strategy of excessive risk-taking<sup>21</sup>. Padoa-Schioppa argues that regulation is essential in order to ensure the maintenance of minimum capital requirements, whilst serving as a threshold which may lead to supervisory intrusion in the event of the deterioration of a bank’s capital position, with this being particularly important since scattered and uninformed depositors cannot induce more prudent management behaviour should there be the need<sup>22</sup>.

Capital adequacy is seen as one of the main safeguards of depositors’ funds and of the banking system in general, coupled with other protections such as depositor insurance

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<sup>19</sup> One should here point out that the reasoning of having higher capital ratios as a safeguard does not necessarily apply just to banks. All undertakings would be considered to be much safer if certain capital ratios were to be adhered to. However regulatory focus was put particularly on banks, mainly in light of the possibility of banks leveraging themselves through deposits taken from the public, and also in light of the systemic risks which banks pose; Padoa-Schioppa Tommaso, *Regulating finance: Balancing freedom and risk* (OUP Catalogue, 2004) 7 – 9.

<sup>20</sup> Wood (n 1) 27.

<sup>21</sup> Padoa-Schioppa (n 19) 7 – 9; See also: Tarullo Daniel K, *Banking on Basel: the future of international financial regulation* (Peterson Institute for International Economics, 2008) 17; It has been argued that banks in weak positions have much to gain from increased risk-taking since if a risk does not pay off, the most shareholders can lose is the capital they would have invested, whilst if the risk does pay off, the weak position would have been reverted, whilst shareholders would stand to benefit from the returns achieved from such risks, particularly since depositors would only be paid pre-stipulated interest rates.

<sup>22</sup> Padoa-Schioppa (n 19) 7 – 9.

(also known as “*depositor guarantee schemes*”), and having central banks acting as lenders of last resort. The attraction of requiring specific amounts of capital to be kept by banks (as against the use of other safeguards of depositors’ funds) arises from the fact that this is not reliant on other banks or on the state since capital must be provided by the bank itself (or through arrangements it makes)<sup>23</sup>. Furthermore capital adequacy acts as an *ex-ante* preventive measure, rather than an *ex-post* solution to a problem which would have already occurred.

The development of the Basel Accords as a transnational system of regulation (through Basel I) was a response to the globalisation of banking, and particularly as a result of the increased provision of services across borders. The main cause for concern in the 1980s was that Japanese banks started to provide their services in the US and in the UK, and with Japanese banks being subject to less stringent regulations and having much lower capital than banks established (and regulated) in these jurisdictions<sup>24</sup>. Japanese banks were increasing their market share here since they were not subject to the same regulatory constraints which local banks faced, and the capital adequacy constraints which had been introduced in the US and in the UK, on banks taking deposits from the public (and which sought to minimise risks to the financial system) were thus being avoided<sup>25</sup>. Thus, banks established and operating in these jurisdictions could not compete with Japanese banks as the latter had a competitive advantage in light of the less stringent regulations to which they were subject<sup>26</sup>.

The developments in capital adequacy regulation in the US were gradual, and whilst regulatory monitoring of capital was present from the early years of the 20<sup>th</sup> century, this had not been set out as an explicit capital requirement. In the late 1930s the Federal Deposit Insurance Corporation (“**FDIC**”) shifted its emphasis to having a ratio of capital to total assets (as against having a ratio of capital to deposits as has had been in place from before the 1930s)<sup>27</sup>. Formal minimum capital requirements however were only

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<sup>23</sup> See also: Tarullo (n 21) 20 – 21.

<sup>24</sup> Barth James R., Caprio Gerard, and Levine Ross, *Rethinking Bank Regulation: Till Angels Govern* (Cambridge University Press, 2006) 64 – 65.

<sup>25</sup> Barth (n 24) 64 – 65.

<sup>26</sup> This also happened following the Latin American debt crisis of the 1980s, when various bank supervisors became concerned about the deterioration in the capital base of most of the main international banks. American regulators were therefore under pressure to either close the doors to foreign international banks or alternatively lower the capital standards to the main western American banks in order to be able to compete with foreign banks. These developments also took place following the dismantling of the Bretton Woods system and the Herstatt Bank failure in the early 1970s. See also: Padoa-Schioppa (n 19) 7 – 9; Tarullo (n 21) 32 – 35.

<sup>27</sup> Tarullo (n 21) 32 – 35.

imposed in the US in the 1980s, as the US Congress passed legislation in 1983 that required federal banking agencies to establish minimum capital levels of banks and bank holding companies, and the FDIC issued final regulations on risk-based capital requirements in 1985<sup>28</sup>.

Though other BCBS countries historically placed less emphasis on capital requirements than the US, as competitive pressures and other developments on banks in the rest of the world paralleled the effects on US banks, supervisors in other countries forming part of the BCBS also started to resort to capital adequacy regulation towards the end of the 1970s and at the start of the 1980s<sup>29</sup>. The EEC Banking Coordination Directive of 1977<sup>30</sup> provided, *inter alia*, for the establishment of capital ratios for “*observational purposes*”, and by 1985, nine of the European countries with representation on the BCBS had already adopted some form of risk weighting in the capital ratios they established (whether as mandatory requirements or as supervisory guidelines), with Italy being the only country which had no specified capital ratios by the time<sup>31</sup>. Similarly Japan also established ratios for supervisory guidance in 1986<sup>32</sup>.

Following pressure which had been applied by the US and the UK, the BCBS agreed to Basel I in 1988, and with this having been adopted by all members by 1992<sup>33</sup>. Basel II was agreed to in 2004, as this sought to deal with the evolving nature of banks and the one-size-fits-all approach which had been adopted by Basel I<sup>34</sup>. Basel II was however never fully implemented as the financial crisis of 2008 led the BCBS to focus on agreeing to Basel III in 2010<sup>35</sup>. Though Basel III established 2019 as the target-date by when it should be adopted, over the past months there have also been discussions about

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<sup>28</sup> *ibid* 36 – 39.

<sup>29</sup> *ibid* 40 – 41.

<sup>30</sup> First Council Directive 77/780/EEC the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [1977] OJ L 322/30.

<sup>31</sup> Tarullo (n 21) 41.

<sup>32</sup> *ibid* 41.

<sup>33</sup> *ibid* 45 – 55.

<sup>34</sup> Wood (n 1) 624.

<sup>35</sup> Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010 (rev June 2011)) (Basel III, 2010); and Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January 2013) (Basel III, 2013; and with: (a) Basel III, 2010; (b) those elements of Basel II which have not been superseded; and (c) further texts which have since been adopted in relation to Basel III; collectively referred to as “**Basel III**”).

possible amendments to Basel III, with these amendments also being, at times, referred to as Basel IV<sup>36</sup>.

Most of the standards adopted throughout the Basel regime along the years followed the US' model, though negotiations between different states have characterized the texts of the Basel Accords. Notwithstanding these various negotiations, there has been no proper consideration or economic analysis carried out in order to determine whether the international standards which have been adopted have the same meaning and whether they can yield the same results in different jurisdictions, as this seems to have been an underlying assumption which all actors took for granted throughout the years.

### 2.1.2 Transnational Law

This thesis adopts Zumbansen's approach to "*transnational law*", which he considers to be a "*methodological approach*", and through which one can study the transformation of legal institutions in societies which are in a continuous process of evolution, and which "*must be seen in the context of a vibrant interdisciplinary discourse about the status and role of law in an increasingly inchoate, globe-spanning web of regulatory regimes, actors, norms and processes*"<sup>37</sup>. He argues that in light of globalisation, the context of "*law*" moves from the "*state*" (which has traditionally been considered as the main "*source*" of law) to the "*society*", which transgresses the concept of nations and states, and includes what Zumbansen refers to as the "*world society*"<sup>38</sup>. In setting out his "*methodological approach*", Zumbansen also notes how considering the different actors, norms and processes "*might offer possible translation and interaction categories to bridge different governance experiences and practise in a transnational context*"<sup>39</sup>, and with this allowing the consideration of patterns of legal ordering in transnational societies<sup>40</sup>. He states that considering "*actors*" allows one to view the various trajectories and conflicts relating to the "*state, society, community, and organization*"<sup>41</sup>. A focus on "*norms*" gives rise to the consideration of historical and comparative perspectives, and the various genealogies and contestations relating to laws, rules, orders, legal pluralism, custom and social norms<sup>42</sup>. Furthermore, the study of "*processes*", allows the study of "*dynamics of*

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<sup>36</sup> Refer to Section 7.3.2 for a discussion on "Basel IV".

<sup>37</sup> Zumbansen (n 9) 3; Zumbansen 2012 (n 9) 308.

<sup>38</sup> Zumbansen (n 9) 3, 4, 8; Verdier 2009 (n 10) 114 – 115; Zumbansen 2012 (n 9) 309.

<sup>39</sup> Zumbansen 2016 (n 9) 41.

<sup>40</sup> Zumbansen 2013 (n 9).

<sup>41</sup> *ibid.*

<sup>42</sup> *ibid.*

*institutional evolution in the complex interplay of norms and actors*"<sup>43</sup>. Thus Zumbansen argues that focusing on "*actors, norms and processes*" allows one to understand better the nature of "*law*" and legal orders as a result of transnational law<sup>44</sup>.

Teubner, however, argues that in light of transnational legal pluralism, contemporary global societies "*must be viewed as comprised of multiple norm systems*", with the result being "*global law without a state*", whereby the various actors in transnational law networks and the industry players found therein "*challenge the supremacy of state-based legal systems for pre-eminence in the production of social norms*"<sup>45</sup>. The role of the state in transnational law and regulation is relevant in this discussion as this thesis will be considering the different actors involved in the iterative processes of law-making through which the Basel Accords have been promulgated and continue to evolve. It will be argued throughout this thesis that the role of the state has changed from being the sole source of "*law*" (when considering "*law*" in traditional national contexts), to that of an actor within a wider recursive process in the promulgation of transnational law and regulation, and with different states acting primarily out of self-interest, with this resulting in inconsistencies in the ways in which the Basel Accords are implemented and enforced throughout different jurisdictions.

### **2.1.3 Theories of Development of Transnational Law**

It has been argued by Slaughter that transnational laws have proliferated in recent years in light of the globalisation of markets. According to the "*globalization theory*", as markets become more globalised, the need for harmonisation between laws of different jurisdictions starts to be considered as the natural solution in order to seek to eliminate problems of regulatory arbitrage<sup>46</sup>. One can argue that this has also been one of the

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<sup>43</sup> *ibid.*

<sup>44</sup> *ibid* 60; See also: Peer C Zumbansen, *The Incurable Constitutional Itch: Transnational Private Regulatory Governance and the Woes of Legitimacy* (Osgoode Hall Law School, Legal Studies Research Paper Series, Research Paper No 18/2014, Vol 10 No 6, 2014) 28 <<https://ssrn.com/abstract=2413160>> accessed 23 January 2017.

<sup>45</sup> Robert Wai, *Transnational Liftoff and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization* (Columbia Journal of Transnational Law, Vol. 40, 2002) 217.

<sup>46</sup> Slaughter has however referred to there being a "*globalisation paradox*" in considering transnational laws as a reply to globalisation, in that though globalisation creates global problems and issues, she considers that it is neither feasible nor desirable to have "*world government*" particularly in light of the lack of democratization and threats to individual freedoms which this may lead to. She therefore sees transnational regulatory networks (as distinguished from transnational laws which are formulated by international institutions, as will be discussed in further detail throughout this Chapter) as providing an ideal framework through which issues created by globalisation can be addressed in a speedy, flexible and inclusive manner.



reasons why the Basel Accords developed – as banks started providing their services across borders in a more globalized world, differences in regulation (and competitive advantages which banks established in certain jurisdictions had) became even more evident and pronounced.

An alternative proposition which has been put forward is that transnational laws develop in order to ensure the rule of law. The “*rule of law theory*” has been embraced by institutions such as the World Bank and the International Monetary Fund (“**IMF**”), and suggests that economic development requires a legal system which safeguards both contractual as well as property rights across borders, both with regard to substantive law, as well as with regard to the judicial administration of those same laws<sup>47</sup>. Thus, whilst the globalization theory considers that transnational law develops as a result of increased economic activity between different jurisdictions, the rule of law theory sets out the establishment of transnational frameworks as being essential for there to be economic cooperation amongst transnational actors.

On the other hand, Cranston argues that transnational laws have developed as a result of market forces, whereby jurisdictions seek to implement and adopt transnational laws in order to be looked at more favourably by potential investors (and particularly since the implementation of transnational laws generally result in such jurisdictions becoming more pro-creditor)<sup>48</sup>. This has become an even more important consideration in recent years as credit rating agencies and international institutions have given value to the adoption of transnational laws by states, with positive reviews going to states which would have positively implemented transnational law and transnational regulatory laws. This has been an essential factor in the adoption of the Basel Accords, which has resulted in these international standards not being adopted only by those jurisdictions which have been involved in the drafting of these international standards, but also by many other jurisdictions across the globe. This thesis will however argue that as a result of varying underlying laws, the same international standards will not necessarily give rise to the same effects and results in different jurisdictions.

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Transnational regulatory networks generally depend on the members of the said network, being domestic regulatory agencies, to “*harden*” the soft laws which such transnational regulatory network would have produced; Anne-Marie Slaughter, *A New World Order* (Princeton University Press, 2004) 8 – 10. See also: Verdier 2009 (n 10) 115, 119 – 120; Annelise Riles, *Managing Regulatory Arbitrage: A Conflict of Laws Approach* (Cornell International Law Journal, Vol. 47, 2014) 69.

<sup>47</sup> Ross Cranston, *Theorizing Transnational Commercial Law* (Texas International Law Journal, Vol. 42, 2007) 598 – 599, 607 – 610.

<sup>48</sup> *ibid* 599, 610 – 613.

It has also been noted by Black and Rouch that the process of convergence of international financial governance, and hence the development of transnational laws, has been most intense following periods of systemic stress and financial crises, as jurisdictions which would have been negatively affected by the crisis feel the need to regulate in order to limit the risks which would have led to the crisis in the first place and to bring confidence back to their markets<sup>49</sup>. Thus, as can be seen from the recent global financial crisis, there has been a surge in transnational law and regulation particularly as a result of various institutions operating across borders, and with benefits being seen in different states cooperating together in order to limit the risks arising from such transnational firms and institutions<sup>50</sup>. It is also clear that Basel III was promulgated as the BCBS' response to the 2007 – 2008 global financial crisis.

#### **2.1.4 Different Strands of Transnational Law**

One can distinguish between three strands of transnational law: *lex mercatoria*; transnational law arising under the auspices of international institutions; and transnational regulatory laws which are developed through transnational regulatory networks. Whilst a review of the relevant literature shows that this has focused on “transnational law” generally, this thesis will argue the importance of distinguishing between “transnational law” and “transnational regulatory law”. Transnational law which has developed as “*lex mercatoria*” is also mentioned for sake of completeness.

Identifying the distinctions between different strands of transnational law is important as this will allow this thesis to frame the Basel Accords in their specific context. As will be seen in Section 2.1.4.3, the nature of the Basel Accords is such that they can be considered to be regulatory laws which are promulgated through transnational networks. Given that the Basel Accords “regulate”, the legitimacy which these international standards have will be very different to that of the *lex mercatoria*, or even transnational laws (adopted through international institutions). It will be shown that each of these strands has different characteristics, both in the way in which they are promulgated and also in the way in which they are adopted by the relevant actors, enforced, and put into practice.

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<sup>49</sup> Julia Black, David Rouch, *The Development of the Global Markets as Rule-Makers: Engagement and Legitimacy* (Law and Financial Markets Review, May 2008) 218 <[http://www.lse.ac.uk/collections/law/projects/lfm/LFMR\\_23\\_BlackRouch\\_218to233.pdf](http://www.lse.ac.uk/collections/law/projects/lfm/LFMR_23_BlackRouch_218to233.pdf)> accessed 10 January 2015.

<sup>50</sup> *ibid* 220.

Transnational laws have taken various forms and consist of more formal methods, such as Treaties, international Conventions, and Model Laws, with these methods typically being established through international law systems and under the auspices of international institutions; as well as more informal methods which are adopted through soft-law arrangements, such as international standards, coordination groups, and even public-private sector partnerships, with these soft-laws being typically formulated through transnational regulatory networks<sup>51</sup>. The success or otherwise of transnational laws has been varied, and the success of transnational law instruments has depended quite heavily on either states being under international peer pressure to adopt specific transnational laws into their own laws, or alternatively on the perceived positive receptability by potential users of such laws. Nevertheless it has been noted by Verdier that “*while it may be rational for states to act through informal networks and agreements in certain circumstances, this does not mean that the results constitute an optimal regulatory outcome from a collective standpoint*”<sup>52</sup>.

#### **2.1.4.1 Lex Mercatoria**

Possibly the first type of “*transnational law*” which has been adopted throughout the years is the “*lex mercatoria*” which found prominence in the Middle Ages. As traders visited different civilizations, they established their own laws through customary practices of trade, and with these laws becoming recognised in international trade and across borders<sup>53</sup>. The *lex mercatoria* re-appeared and once again found its place in international trade law after the second world war, and was given further impetus after the “*London Colloquium on the New Sources of the Law of International Trade*” held at King’s College, London, in September 1962<sup>54</sup>.

An important feature of the *lex mercatoria* is that these laws are allowed to operate without the need of underlying national laws<sup>55</sup>. *Lex mercatoria* is therefore considered to regulate the relationship of traders between each other, and therefore are, of their nature, a system of private law regulating contractual terms between similar entities. The main focal point of the *lex mercatoria* is that “*the international community of merchants creates its own law through decentralized ‘autonomous’ law-making*”

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<sup>51</sup> Cranston (n 47) 597, 598.

<sup>52</sup> Verdier 2009 (n 10) 168.

<sup>53</sup> Cranston (n 47) 605; Zumbansen (n 9) 7.

<sup>54</sup> *ibid*; Klaus Peter Berger, *The Creeping Codification of the New Lex Mercatoria* (Kluwer Law International, 2010) 67; Chia-Jui Cheng, *Clive M. Schmitthoff's Select Essays on International Trade Law* (Martinus Nijhoff Publishers and Graham & Trotman Ltd, 1988) 135; Berger (n 54) 3 – 4.

<sup>55</sup> Cranston (n 47) 605; Zumbansen (n 9) 7.

processes”<sup>56</sup>. Today this continues to operate in international trade, including through the formalization of international commercial practices, and with the possibility of disputes being resolved through international arbitration.

#### **2.1.4.2 Transnational Law Developed under the Auspices of International Institutions**

The proliferation of transnational laws has been driven particularly by international institutions such as the United Nations Commission on International Trade Law (“UNCITRAL”), the International Institute for the Unification of Private Law (“UNIDROIT”), the World Bank, and others<sup>57</sup>, with the aim of replacing the various rules found in different legal systems, with one unified law which can also be made use of by different jurisdictions<sup>58</sup>. Transnational laws seek to achieve uniformity through two different methods – either through the establishment of rules which private parties can refer to in their private contracts, such as the UNCITRAL Arbitration Rules; or alternatively through the establishment of Treaties and with states then subscribing or acceding to such Treaties and ensuring that the said transnational laws which would have been agreed to are adopted into their own national laws<sup>59</sup>.

On subscribing or acceding to a Treaty, states may make specific declarations should they elect to depart from the agreed text<sup>60</sup>. Though contracting states will be bound, internationally, by a Treaty, the Constitutional laws of that same state will then determine whether the Treaty takes the force of national law immediately, without there being the need of an implementing law (also referred to as “*monism*”), or whether national legislation would be needed in order for the provisions thereof to take effect (also referred to as “*dualism*”)<sup>61</sup>.

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<sup>56</sup> Berger (n 54) 58 – 64.

<sup>57</sup> Cranston (n 47) 597; William A Lovett, *Transnational Finance Regulation and the Global Economy* (Tulane Journal of International and Comparative Law, Vol. 20, 2011) 43 – 50; Wai (n 45) 209 – 212; Lucia Quaglia, *The European Union, the USA and International Standard Setting by Regulatory Fora in Finance* (New Political Economy, Vol. 19, No. 3, Routledge, 2014) 427 <<http://dx.doi.org/10.1080/13563467.2013.796449>> accessed 9 January 2015.

<sup>58</sup> Cranston (n 47) 606.

<sup>59</sup> *ibid* 599, 606.

<sup>60</sup> *ibid* 599.

<sup>61</sup> Jeffrey Wool and Andrej Jonovic, *The Relationship Between Transnational Commercial Law Treaties and National Law – A Framework as Applied to the Cape Town Convention* (Cape Town Convention Journal, September 2013) 67 <<http://www.ingentaconnect.com/content/hart/ctcj/2013/00002013/00000001/art00005>> accessed 20 January 2015.

From an international law perspective it is assumed that an international treaty which will be subscribed to or acceded by a state will obtain primacy over other conflicting national laws, thus having the same Treaty being applied consistently throughout all the states which would be a party thereto<sup>62</sup>. Article 27 of the Vienna Convention on the Law of Treaties states that, “[a] party may not invoke the provisions of its internal law as justification for its failures to perform a treaty”<sup>63</sup>. This is enhanced by the fact that in many states, Treaties are considered as being amongst the “highest legal norms”, thus enhancing the primacy element of Treaties<sup>64</sup>.

Treaties, “increasingly, are based on *sui generis* concepts derived from the instrument itself” and not from any particular national law<sup>65</sup>. This helps to reduce variances in underlying national laws within which these Treaties must operate, as their interpretation need not rely on underlying concepts of national law<sup>66</sup>. This is complemented by the principle of international law known as the “*autonomous interpretation principle*” which requires that terms of a Treaty are interpreted just within the context of that Treaty itself, without referring to national law concepts<sup>67</sup>. This principle is generally reflected in Treaties themselves and is also supported by national legislation and case law<sup>68</sup>.

The development of international institutions through which transnational laws are promulgated has however given rise to “*regulatory gaps*” on the international scene, with this being considered as the main inhibiting factor towards the development of transnational laws<sup>69</sup>. Financial governance also has become heavily reliant upon what has been described as a “*complex network of regional and global legal and political groupings*”, which itself depends upon the interaction amongst international institutions and any transnational regulatory networks which may have been established<sup>70</sup>. Furthermore, as Quaglia emphasises, the development of transnational financial services

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<sup>62</sup> *ibid* 67.

<sup>63</sup> Article 27, Vienna Convention on the Law of Treaties (Vienna, 1969).

<sup>64</sup> Wool and Jonovic (n 61) 73.

<sup>65</sup> *ibid* 69. See also: Wool 2003 (n 5) 392.

<sup>66</sup> Wool and Jonovic (n 61) 69; Wool 2003 (n 5) 392.

<sup>67</sup> Wool and Jonovic (n 61) 69.

<sup>68</sup> *ibid*.

<sup>69</sup> See also: Wai (n 45) 250 – 252.

<sup>70</sup> Black and Rouch (n 49) 218.

laws has been due to “*the interaction between institutions and rulemaking processes across multiple arenas*” and the “‘*accommodation*’ or ‘*coexistence*’ of their outputs”<sup>71</sup>.

The presence of international institutions has helped the development of a form of transnational financial governance following the financial crisis, since, as Black argues, “*markets tend not to wait for perfection, but to work with what they have*”<sup>72</sup>. This has meant that following the financial crisis, institutions such as the IMF and the BCBS (the nature of which is actually of a transnational regulatory network, as will be discussed in further detail below) have aimed to establish the relevant laws needed to deal with problems the global financial crisis exposed. Following the financial crisis there also has been further organisation and interplay between these standard-setting bodies<sup>73</sup>. Furthermore, regional groupings such as the EU, have also taken initiatives in international or regional standard setting, and harmonisation of laws and mutual recognition of laws<sup>74</sup>. On the other hand, however, notwithstanding the development of these international institutions, there also have been conflicting policy dynamics with the internationalisation of law being challenged by pressures for unilateralism by both individual states (such as through Brexit) and by regional groupings generally (such as the EU)<sup>75</sup>.

#### **2.1.4.3 Transnational Regulatory Laws and Transnational Regulatory Networks**

A review of the literature reveals an additional focus within transnational legal scholarship, that is described as “*transnational regulatory law*,” which considers the function and role of transnational regulatory networks. The Basel Accords may be viewed as a primary example of a transnational regulatory law which has been promulgated by transnational regulatory networks, and which has developed as a result of having national regulators negotiate with each other in order to solve common problems, with this being hailed as allowing a “*democratic shift from “hierarchies to networks”*”<sup>76</sup>.

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<sup>71</sup> Quaglia (n 57) 427.

<sup>72</sup> Black and Rouch (n 49) 218.

<sup>73</sup> *ibid.*

<sup>74</sup> *ibid* 219 – 221.

<sup>75</sup> Julia Black, *Restructuring Global and EU Financial Regulation: Character, Capacities, and Learning* (2012) 5, 9 – 10 <<http://www.pbookshop.com/media/filetype/s/p/1348259314.pdf>> accessed 10 January 2015.

<sup>76</sup> Narissa Lyngen, *Basel III: Dynamics of State Implementation* (Harvard International Law Journal, Vol 53, No 2, Summer 2012) 521.

Transnational regulatory networks such as the BCBS and the International Organization for Securities Commissions (“**IOSCO**”) hold no legal personality or status, other than that conferred on the specific organisation by the host country where such organization is formed, and hence are not considered to be bodies which have a specific status under international law<sup>77</sup>. Though the BCBS is attached to the Bank for International Settlements (“**BIS**”), which is an international institution, it is not an official organ thereof, and is only composed of members from Central Banks and banking supervisory authorities from the states forming part of the said Committee<sup>78</sup>.

Here, national regulatory agencies negotiate directly with regulatory agencies from other jurisdictions in order to solve common problems which traditional international institutions cannot address (particularly since adoption and implementation of any such standards will need to take place through these same regulatory agencies)<sup>79</sup>. Furthermore, regulatory networks such as the BCBS do not have any formal monitoring, review or enforcement mechanisms in place<sup>80</sup>.

Thus, in transnational regulatory networks it is not states which come together to cooperate with each other, but different “*national regulatory agencies*”<sup>81</sup>. Furthermore these national regulatory agencies are usually faced with similar problems, and they typically have much more in common with each other, rather than with other public sector officials in their home jurisdictions<sup>82</sup>. As will be discussed below, as states become “*actors*” in the promulgation of transnational regulation, states themselves cannot be considered to have monist interests, but different players in a particular state may have varying interests depending on the role they play within the state.

According to Slaughter, these regulatory networks “*are not “inter-state” organizations; they are not formed by treaty or even executive agreement; they have no place on the landscape of the international legal system*”<sup>83</sup>. Thus these national regulatory agencies negotiate with their counterparts, who face similar issues, whilst sharing best practices and seeking common solutions to common problems, away from domestic political pressures which might otherwise hinder the actual promulgation of certain rules which might be controversial should they have been promulgated on a national plain (though

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<sup>77</sup> Slaughter (n 46) 43; Verdier 2009 (n 10) 118.

<sup>78</sup> Berger (n 54) 41 – 42.

<sup>79</sup> Verdier 2009 (n 10) 115.

<sup>80</sup> *ibid* 132.

<sup>81</sup> *ibid* 118.

<sup>82</sup> Tsingou (n 17) 139; See also: Lyngen (n 76) 521.

<sup>83</sup> Slaughter (n 46) 38, 43.

as argued by Verdier in reality these domestic regulatory agencies do not operate as freely as argued by other authors and still continue to be subject to domestic political pressures)<sup>84</sup>.

Membership in transnational regulatory networks is typically selective, and decisions are usually taken through the attainment of consensus by the participating members<sup>85</sup>. They also typically operate through the adoption of international standards which take the form of “*soft law*”, and therefore do not establish Treaties, which would create legal obligations between states<sup>86</sup>. Furthermore they usually neither provide for supervision and enforcement mechanisms, nor for conflict resolution procedures, which would typically be found in formal treaties and institutions<sup>87</sup>. It has been stated that states therefore prefer liaising with each other through transnational regulatory networks, such as the BCBS, rather than through international institutions, for matters such as banking regulation<sup>88</sup>.

One must also consider that similar to national regulatory agencies, as transnational regulatory networks are established, these networks need to justify their existence and promote their usefulness in order for them to survive. Therefore bodies such as the BCBS have had to respond to international situations such as the global financial crisis in order to continue to justify their existence particularly in light of the failure of the international standards which they had established. These bodies have their own political motivations of ensuring their relevance on the international plain, also in light of arguments against their legitimacy, which will be discussed in further detail in Chapter 4. Failing to act may therefore render these transnational regulatory bodies irrelevant, with the possibility also of being made “*scapegoats*” for events such as the global financial crisis.

Transnational regulatory laws differ from the other types of transnational law discussed previously. Transnational regulatory laws are “*regulatory*” in nature and they therefore typically impose limitations and restrictions on private parties, whilst being only “*soft laws*”. Hence, issues such as “*legitimacy*” and “*accountability*” of transnational regulatory networks play a much bigger role here than in other types of transnational laws.

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<sup>84</sup> Verdier 2009 (n 10) 115, 129.

<sup>85</sup> *ibid*; Joel P. Trachtman, ‘Addressing Regulatory Divergence Through International Standards: Financial Services’ in Aaditya Mattoo and Pierre Sauvé (eds), *Domestic Regulation & Service Trade Liberalization* (World Bank and Oxford University Press, 2003) 33.

<sup>86</sup> Verdier 2009 (n 10) 118; Trachtman (n 85) 27 – 28.

<sup>87</sup> Verdier 2009 (n 10) 118, 130.

<sup>88</sup> Tsingou (n 17) 140.



Transnational regulatory laws are also dependent upon national regulators to give effect to the regulations which would have been agreed to at a transnational level, by hardening the soft laws which would have been established by the transnational regulatory networks. As will be discussed later on in this Chapter, the national regulators which are tasked with implementing and enforcing transnational regulatory laws also may be subject to regulatory capture (and have along the years also been criticized for lacking legitimacy and accountability)<sup>89</sup>.

“Soft laws” in transnational regulatory network theory have been considered to be an effective solution to issues which arise across borders<sup>90</sup>. The advantages seen in having transnational regulatory networks operating through “soft law” are that as states need to “harden” these laws according to their own particular needs, fewer costs are incurred in promulgating these laws, as soft laws are considered to be more flexible than an imposition of one “hard” law made applicable to all states (since otherwise one hard law would have to cater for all permutations and combinations of national laws)<sup>91</sup>. Furthermore, soft-laws have been preferred in this context, as there is seen to be less loss of sovereignty by states given that these soft-laws require “hardening” by national regulatory agencies<sup>92</sup>. “Soft laws” established by transnational regulatory laws may be “hardened” through judicial or legislative recognition at a national level, or they may also become directly applicable through laws promulgated by regional groupings such as the EU (which, by way of example, applied the Basel III provisions through the promulgation of the Capital Requirements Regulation (“CRR”), which is directly applicable in each of the member states of the EU)<sup>93</sup>.

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<sup>89</sup> Avgouleas (n 11) 354.

<sup>90</sup> *ibid* 353.

<sup>91</sup> *ibid*.

<sup>92</sup> *ibid*.

<sup>93</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance [2013] OJ L 176/1 (CRR); Black and Rouch (n 49) 224. At the time of writing discussions are ongoing for the CRR to be amended by what is being referred to as “CRR II”; See: European Commission, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements for Own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties; Exposures to Collective Investment Undertakings, Large Exposures, Reporting and Disclosure Requirements and Amending Regulation (EU) No 648/2012* (COM (2016) 850 final, 2016/0360 (COD), Brussels, 23 November 2016) <<https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF>> accessed 22 February 2017; and Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013*

States tend to prefer resorting to transnational regulatory networks and soft law, over formal laws which may take the form of Treaties governed by international law, where there is uncertainty and the need for flexibility in adopting global standards, such as is the case with the Basel Accords<sup>94</sup>. Given that there is less of a formal commitment (when compared to transnational laws such as Treaties), states may be more willing to adopt principles through soft-law in order to have flexibility in adopting the said principles and without having to rely on formal ratification procedures for implementation<sup>95</sup>. Furthermore, reputational costs for not strictly complying with the particular standards are much lower than those emanating from instruments of international law<sup>96</sup>.

Soft-laws do not give rise to binding legal obligations between states and are only created with the expectation that they “*would be given some indirect legal effect through related binding obligations under either international or domestic law*”<sup>97</sup> (and with this also having been recognised by the Vienna Convention on the law of Treaties<sup>98</sup>). “*Soft-law*” has been defined by what “*it is not*”, as it is considered to be “*not legally binding*”, “*not in treaty form*”, and does “*not belong to the category of customary law*”, and therefore at times certain legal scholars have even rejected the idea of referring to “*soft law*” as “*law*”<sup>99</sup>.

Brummer observes that soft-law does not “*express any special solemnity of commitment*” in the same way as hard law does (through the Vienna Convention on the law of Treaties), and is considered to be “*devoid of any legal obligation, imposes few defection costs and enables what can be described as “cheap” exit from commitments*”<sup>100</sup>.

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*as regards the Leverage Ratio, the Net Stable Funding Ratio, Requirements for Own Funds and Eligible Liabilities, Counterparty Credit Risk, Market Risk, Exposures to Central Counterparties; Exposures to Collective Investment Undertakings, Large Exposures, Reporting and Disclosure Requirements and Amending Regulation (EU) No 648/2012 – Presidency Compromise (Interinstitutional File 2016/0360 (COD), 6614/18, Brussels, 6 March 2018) <<http://data.consilium.europa.eu/doc/document/ST-6614-2018-INIT/en/pdf>> accessed 4 May 2018 (CRR II).*

<sup>94</sup> Verdier 2009 (n 10) 167.

<sup>95</sup> *ibid.*

<sup>96</sup> *ibid.*

<sup>97</sup> Timothy Meyer, *Soft Law as Delegation* (Fordham International Law Journal, Vol. 32, 2009) 889 – 890.

<sup>98</sup> *ibid* 906.

<sup>99</sup> Sylvia I Karlsson-Vinkhuyzen and Antto Vihma, *Comparing the Legitimacy and Effectiveness of Global Hard and Soft Law: An Analytical Framework* (Regulation & Governance, Vol. 3, Issue 4, 2009) 402 <<http://onlinelibrary.wiley.com/doi/10.1111/j.1748-5991.2009.01062.x/abstract>> accessed 2 March 2016.

<sup>100</sup> Chris Brummer, *How International Financial Law Works (and How it Doesn't)* (The Georgetown Law Journal, Vol 99, 2011) 271.

Nevertheless, he notes that international financial regulation developed through soft law is “often buttressed by a range of reputational, institutional, and market disciplines that render it more coercive than traditional theories of international law predict”<sup>101</sup>, such that soft law may be “‘harder’ than traditional public international law anticipates”<sup>102</sup>. This thesis however argues that this is not the case with the Basel Accords which continue to be subject to substantial differences across jurisdictions in both its scope and effect.

Furthermore, this thesis will argue that one of the main problems of international standards and international rules such as those set out by the Basel Accords is that there is a lack of uniformity of interpretation and application due to differences which arise in the legal frameworks of different jurisdictions (also referred to as “*domestic embeddedness*” or “*cultural embeddedness*” throughout this thesis). These issues arise even when considering Treaties (and which consist of transnational law established by international institutions), but are much more limited there, given the application of the “*primary principle*” and the “*autonomous interpretation principle*”<sup>103</sup>. When seeking to achieve uniformity through transnational regulatory laws through the use of soft law, domestic and cultural embeddedness become much more of a problem, given that the particular transnational regulatory law (such as the Basel Accords), needs to operate within different national law frameworks, and with different rules of interpretation being applied across different jurisdictions.

Though it has been argued that the main advantage of using soft-law is that states may adopt varying texts according to their own circumstances and requirements, and as these circumstances and requirements change from time to time (without the need for formal amendments to be agreed to by other states), it is here argued that the use of soft-law in the Basel Accords is somewhat paradoxical. Both Basel II and Basel III have each been drafted in a way which is not simply based on “*principles*” (as had been the case with Basel I), but they have both laid out very detailed provisions which national regulators are expected to follow without being subject to significant variations in the way they are adopted. This means that whilst the drafting style adopted is such that there should be no room for interpretation in the way in which the Basel Accords are to be adopted, national regulators still retain discretion in practice, given that the Basel Accords are only adopted through soft-law. Consequently, notwithstanding the very

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<sup>101</sup> *ibid* 284.

<sup>102</sup> Chris Brummer, *Why Soft Law Dominates International Finance – And Not Trade* (Journal of International Economic Law, Vol 13 No 3, Oxford University Press, 2010) 637 – 638.

<sup>103</sup> See also: Wool and Jonovic (n 61) 67.

detailed international standards which have been agreed to transnationally, national regulators are still free to depart from the Basel Accords (and with this thesis also arguing that states may also have incentives in departing from the provisions of the Basel Accords). This has also given rise to the possibility of regulatory arbitrage opportunities to the industry as will be discussed in further detail in Chapter 5.

## **2.2 *Transnational Regulatory Bodies and Decision-Making Structures***

This foregoing Section has considered three different categories of “*transnational law*”, and has identified the Basel Accords as a “*transnational regulatory law*” which is formulated through “*transnational regulatory networks*”. This Section will analyse the main influences on transnational regulatory networks. This will be done by considering the ways in which transnational networks operate and how entities in these networks liaise amongst themselves, and also the various influences which affect the decision-making of these networks and their participants. This thesis will argue that in order to reduce regulatory arbitrage opportunities there needs to be a further shift towards allowing regulatory competition to take place amongst different states, but with this subject to certain binding principles which would prevent there being a “*race-to-the-bottom*”. Finally, whilst this Section will consider a number of matters which influence the ways in which national regulatory agencies act, Part IV of this thesis will also argue that the Basel Accords cannot have the same effect in different jurisdictions due to differences in national laws and national preferences.

### **2.2.1 Transnational Regulatory Bodies and Structures of Interaction**

Institutional structures and transnational regulatory bodies play a significant role in the development of transnational laws and regulations, and this can also be said in relation to the development of the Basel Accords.

Black has identified four main structures through which regulatory bodies interact across jurisdictions, and which she refers to as “*institutional structures for control*” (which may apply to both “*international institutions*” as well as “*transnational regulatory bodies*”), with these institutional structures being organized through “*hierarchy*”, “*community*”, “*markets/ competition*”, and “*managed networks*”<sup>104</sup>. She notes how international institutions, such as the Financial Stability Board (“**FSB**”) are seeking to use each of “*hierarchy*”, “*community*” and “*managed networks*” in order to reach their goals,

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<sup>104</sup> Black (n 75) 32.

whilst on the other hand, the EU (as an economic bloc) is using “*hierarchy*” (though Slaughter has been of the view that “*the European Union has pioneered “regulation by networks”*”)<sup>105</sup>. Black also explains that the financial crisis has shown the limits of the “*markets/ competition*” approach and that “*there is little faith in the idea that coordination can be achieved through the “invisible hand” of the self interests of participants*”<sup>106</sup>.

As will be argued below, whilst the BCBS works through a system of managed networks, there have been elements of each of the different structures of interaction. Each of these four structures will be described in further detail, together with the extent to which these structures have been relevant in the formulation of the Basel Accords throughout the years. This thesis will argue that whilst each of these four different structures has played its part in the development of the Basel Accords, further importance needs to be given to markets/ competition in order to increase the legitimacy of the Basel Accords and allow national regulators to apply transnational standards within varying contexts at a national level.

#### **2.2.1.1 Hierarchy amongst Regulatory Bodies**

“*Hierarchy*” refers to an organisational structure through which different regulatory bodies are subordinate to each other, with promulgation and enforcement of rules taking place through top-down institutional and control structures<sup>107</sup>. Following the financial crisis there has been a further shift towards hierarchical regulation, with international institutions and transnational regulatory networks seeking to obtain further power for themselves<sup>108</sup>. Black however has been critical of this top-down approach particularly in light of the further rigidities which this system continues to introduce<sup>109</sup>.

While an element of hierarchy is present in the BCBS in that it is this entity which establishes the relevant standards to be followed, the functions which it carries out are effected in the spirit of network management strategies and of regulatory cooperation. Whilst an element of hierarchy does exist in the promulgation of the Basel Accords, this is not as explicit as it would be in the context of other international institutions.

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<sup>105</sup> The European Union has also been formed through markets and regulatory competition particularly where the EU made use of minimum harmonisation directives; Black (n 75) 32; Slaughter (n 46) 8.

<sup>106</sup> Black (n 75) 32.

<sup>107</sup> *ibid.*

<sup>108</sup> *ibid* 4.

<sup>109</sup> *ibid.*

Nevertheless, as transnational regulatory networks become more formalised and take up greater roles and responsibilities, the hierarchical element tends to increase.

#### **2.2.1.2 Community and Regulatory Cooperation**

In “community” or “regulatory cooperation”, regulatory agencies from different jurisdictions converge with a view to cooperating amongst themselves, and harmonising their regulations, thereby resulting in different jurisdictions adopting roughly similar regulatory standards<sup>110</sup>. In a system where regulatory systems are harmonised across different jurisdictions, states do not compete with each other, but they work together in order to achieve a common goal, therefore seeking to eliminate competitive advantages which states may have over each other<sup>111</sup>. It has been argued that regulatory cooperation is essential when regulating international banking activities, particularly in light of the cross-border activities undertaken by international financial entities, which may generate transnational externalities<sup>112</sup>.

Regulatory cooperation assumes that states will prefer the safety and soundness of the financial system over competition between states which may lead to a “race-to-the-bottom”. This would result in industry players having limited incentives to move from one jurisdiction from another, given that each jurisdiction would be adopting substantially the same standards and would be working together in order to enforce common standards<sup>113</sup>.

Regulatory cooperation assumes that regulators acting in cooperation know what the optimum level of regulation for the market is<sup>114</sup>. There is also a risk that a harmonised system of regulation results in higher regulatory demands by regulators given the lack of competition between different jurisdictions (though Pan argues that savings are also made by the industry and by the regulators in that they do not need to expend time and money to understand the different systems which would otherwise be in place)<sup>115</sup>.

Regulatory cooperation typically has developed through the adoption of national laws which were “uploaded” to the international community, giving a first-mover advantage

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<sup>110</sup> Eric J. Pan, *Structural Reform of Financial Regulation* (Transnational Law & Contemporary Problems, Vol. 19, Winter 2011) 814.

<sup>111</sup> George J. Benston, *Regulating Financial Markets: A Critique and Some Proposals* (The Institute of Economic Affairs, Hobart Paper 135, 1998) 115.

<sup>112</sup> Michael S. Barr and Geoffrey P. Miller, *Global Administrative Law: The View from Basel* (The European Journal of International Law, Vol. 17, No. 1, 2006) 21.

<sup>113</sup> Pan (n 110) 814.

<sup>114</sup> *ibid.*

<sup>115</sup> *ibid.*

to those jurisdictions with “*strong*” laws.<sup>116</sup> Quaglia has argued that since rules on capital adequacy were already present in the US prior to the adoption of Basel I, this allowed the US to “*upload*” their laws to the international community, whilst Basel III was influenced by both US and EU laws<sup>117</sup>. This suggests that regulatory cooperation may also be influenced by national laws of participants in regulatory cooperation.

States or their regulatory agencies here act together, either voluntarily (through common interests, co-operation, and capacity building) or alternatively through peer pressure being put on certain states, by other states or entities<sup>118</sup>. Black however recognises that community systems based on peer pressure and peer support are less likely to be successful when participants have conflicting goals, objectives and interests, and have incentives to compete against each other<sup>119</sup>.

It is argued throughout this thesis that given that states act out of self-interest, they may have adopted the Basel Accords throughout the years only as a result of peer pressure being exerted upon them by other states or by international bodies (and not out of a desire to enter into a regulatory cooperative framework), and with this also resulting in “*cosmetic compliance*” with the international standards. By way of example, the US and the UK originally had pushed for the adoption of the Basel Accords by other jurisdictions, only due to the competitive disadvantage which they had when compared to Japanese banks<sup>120</sup> (and after this the US did not fully adopt Basel II<sup>121</sup>). On the other hand, Japan only adopted the Basel Accords out of peer pressure (as was also the case with a number of other emerging jurisdictions)<sup>122</sup>. Furthermore, Continental jurisdictions have adopted capital adequacy regulations which are based on an Anglo-Saxon system of banking, and which are fundamentally different to those found in a Continental system<sup>123</sup>. Moreover,

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<sup>116</sup> Quaglia (n 57) 430 – 431.

<sup>117</sup> *ibid* 438.

<sup>118</sup> Black (n 75) 32.

<sup>119</sup> *ibid* 33.

<sup>120</sup> Tarullo (n 21) 46 – 51.

<sup>121</sup> See: European Parliament, *US Implementation of Basel II: Final Rules Issued, But No Supervisory Approvals To Date* (European Parliament, Directorate General for Internal Policies, Policy Department, Economic and Scientific Policy, October 2011 IP/A/ECON/NT/2010\_22) <<http://www.europarl.europa.eu/document/activities/cont/201110/20111012ATT29102/20111012ATT29102EN.pdf>> accessed 28 January 2017.

<sup>122</sup> Hyoungh-kyu Chey, *International Harmonization of Financial Regulation?: The politics of global diffusion of the Basel Capital Accord* (Routledge, 2014)3, 53 - 68; Tarullo (n 21) 50 – 51.

<sup>123</sup> Quaglia (n 57) 438.

Basel III was only agreed to by the international community as something needed to be seen as having been done following the global financial crisis<sup>124</sup>.

### **2.2.1.3 Managed Networks**

The development of transnational regulatory networks continues to play an important role in developing facilitative law allowing cross-border economic activity to operate within a defined structure which can be adopted across borders<sup>125</sup>. The BCBS is probably one of the best examples as to how managed networks work.

“*Network management strategies*” occur when parties seek to establish procedures which would facilitate concerted actions, by establishing processes which encourage negotiations towards consensus<sup>126</sup>. Black describes this process as involving<sup>127</sup>:

*creating a governance mechanism for the network which establishes agendas rather than common goals; creates communications channels; makes ad hoc arrangements to support collective action; brokers solutions by bringing problems, solutions and parties together; promotes favourable conditions for joint action; or manages conflicts through mediation and arbitration.*

Attempts at harmonisation through transnational regulatory networks, such as in the BCBS, have also been viewed as being a product of a “*transnational policy community of expert actors*”, whereby national regulatory agencies from different jurisdictions (as against states), form into transnational regulatory networks and transnational regulatory agencies, in light of having a similar mindset and due to having been subject to similar issues and problems at a national level<sup>128</sup>. Thus, regulatory agencies push forward and encourage transnational cooperation due to the similarities between them, rather than due to the similarities which may exist between the states they represent.

Transnational regulatory networks also contain elements of liberal internationalism, particularly in light of these networks developing against a backdrop of neoliberal economic practice<sup>129</sup>. Wai explains that liberal internationalism contains three distinct sets of policy objectives: the economic objective of facilitating international commerce;

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<sup>124</sup> Morten Balling and others, *New Paradigms in Banking, Financial Markets and Regulation?* (SUEF: The European Money and Finance Forum, Vienna 2012) 66 <<http://www.suerf.org/download/studies/study20122.pdf>> accessed 3 October 2014.

<sup>125</sup> Cranston (n 47) 600 – 601.

<sup>126</sup> Black (n 75) 32.

<sup>127</sup> *ibid* 33.

<sup>128</sup> Quaglia (n 57) 429.

<sup>129</sup> Tsingou (n 17) 139.



the political objective of increasing interstate cooperation; and the moral objective of avoiding parochialism and promoting non-discrimination<sup>130</sup>. Adopting a policy of liberal internationalism results in jurisdictions gearing their policies towards long-term cooperative benefits, towards the general good of all states which adopt such measures, as against a policy of short-termism where states compete against each other with the potential of having a “*race to the bottom*”<sup>131</sup>. On the other hand, however, one of the main criticisms of liberal internationalist policy is that this frequently adopts a “*technical and necessitarian approach, which fails to recognize that societies have alternative strategies in adapting national laws to the challenges of global society*”<sup>132</sup>. This results in global reform which would typically be “*simplistic*” and which would have been entered into in light of global conditions at the time, or because of the perceived need to promote an international system<sup>133</sup>.

As detailed in Section 2.1.4.3, the BCBS is primarily a transnational regulatory network which provides a framework through which national regulatory agencies meet to discuss the main issues they would be facing and possible solutions to their problems. The BCBS thus allows for continuous dialogue amongst its members, with the establishment of a so-called “*communication channel*”, whereby the agenda of each member can be discussed with counterparts from different states. However, the way in which agreement or “*consensus*” is reached, throughout negotiations on the Basel Accords, seems to have various elements of Habermas’ “*non-rational*” debate, which Black describes as follows<sup>134</sup>:

*... a discourse which is not differentiated by different illocutionary meanings of ‘ought’ but which is characterized by conflict and lack of consensus, with no clear priority of value emerging. In such situations, discourse takes the form of bargaining and compromise, of balancing of interests, where agreement is reached but is accepted by the parties for their own different reasons. The outcome is not due to the force of the better argument but to the material or power differences between the parties, and achieved through threats and promises that rob the shared use of language of its illocutionary binding force.*

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<sup>130</sup> Wai (n 45) 224.

<sup>131</sup> *ibid.*

<sup>132</sup> *ibid* 229.

<sup>133</sup> *ibid* 229 – 230.

<sup>134</sup> Julia Black, *Proceduralizing Regulation: Part II* (Oxford Journal of Legal Studies, Vol. 21, No. 1, 2001) 42.

This mainly arises as states continue to have their own individual interests at heart, which also include gaining competitive economic advantages over other states which form part of the same managed network.

#### **2.2.1.4 Markets and Regulatory Competition**

*“Regulatory competition”* suggests that markets are left to operate freely, with each state acting out of self-interest in setting up its regulations, and with financial entities and capital moving freely between these same states<sup>135</sup>. Assuming rational choices are made financial entities will establish themselves or move to those states where there exists the optimum mix between sufficient regulatory protection and where the burden of regulatory compliance is reasonable but not excessive, thus leading to efficient markets and efficient regulation<sup>136</sup>. This system encourages regulatory agencies to modify and tweak their regulations in accordance with feedback received from the market, in order to ensure that their system provides a competitive edge over that of other jurisdictions<sup>137</sup>. Regulatory competition therefore requires regulators to innovate in order to ensure that appropriate and adequate regulation can regulate ever-changing markets without being too burdensome<sup>138</sup>.

In order for regulatory competition to work perfectly, market participants need to have complete information as to the attributes of the laws and regulations of different jurisdictions, and have the necessary skills to evaluate such laws and regulations and their appropriateness for their particular needs<sup>139</sup>. Regulators, on the other hand, would also need to have sufficient resources in order to engage in a competitive environment, both to keep abreast with developments carried out by regulated entities, as well as in order to understand the regulatory responses of other jurisdictions<sup>140</sup>. The social costs of regulatory competition may be high, though the *“winners”* in a competitive environment would stand to gain as investment moves from one state to another.

In the long run, regulatory competition would lead to the most efficient form of regulation, as private entities move towards jurisdictions which have more efficient regulation, as jurisdictions amend their laws in order to catch up with jurisdictions which would have a competitive edge over them, and as those jurisdictions which do not

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<sup>135</sup> Pan (n 110) 812.

<sup>136</sup> *ibid.*

<sup>137</sup> *ibid* 812 – 813.

<sup>138</sup> Barr and Miller (n 112) 20.

<sup>139</sup> Pan (n 110) 814.

<sup>140</sup> *ibid.*

provide a sufficient level of regulation face the wrath of the market (as in the financial crisis).

It has been argued that the establishment of transnational regulatory standards by the Basel Accords inhibits regulatory competition, thus hindering efficient regulation<sup>141</sup>. Harmonization through international standards results in regulation being inflexible such that it cannot be responsive to market changes, rendering it inefficient<sup>142</sup>. However, though regulatory competition is not the main recognised method of interaction between states in the BCBS, it still takes place tacitly. Pan has highlighted how “[t]o the extent national regulators operate independently of one another, they will always face competitive pressure and must be prepared to implement regulatory strategies that make their markets more attractive”<sup>143</sup>, and that even during times of crisis, “financial market participants are mobile and have choices”<sup>144</sup>. If a state manages to be competitive, whilst also ensuring the safety and soundness of the financial system, then this will “have great benefits for a country, including, among other things, lower cost of capital for businesses, greater opportunities for investors, tax revenue for government, and job creation in the financial and related industries”<sup>145</sup>. Regulation has a role to play in making a jurisdiction more competitive and states must consider “how to attract financial activity”<sup>146</sup>, particularly since they stand to benefit if they manage to provide a competitive environment when compared to competing jurisdictions<sup>147</sup>.

When considering transnational regulation such as the Basel Accords, jurisdictions tend to compete with one another by implementing variants of transnational regulation, resulting in partial or only superficial adoption of transnational regulation. This will allow it to have the benefit of both worlds, since it will be able to proclaim that it would have implemented the relevant international standards, whilst at the same time providing ways and means through which the provisions of those same international standards could be watered down in order to provide competitive advantages over other states. Avgouleas has explained that the endorsement or otherwise of a particular regulatory standard by regulators will vary, since whilst some regulators may view the need to implement certain stringent regulatory standards in order to show their

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<sup>141</sup> Barr and Miller (n 112) 20.

<sup>142</sup> *ibid.*

<sup>143</sup> Pan (n 110) 800, 801.

<sup>144</sup> *ibid* 801.

<sup>145</sup> *ibid* 801, 807 – 808.

<sup>146</sup> *ibid* 802 – 803.

<sup>147</sup> Verdier 2009 (n 10) 133.

commitment to a sound regulatory system, other regulatory agencies may be more prone towards implementing lower regulatory standards in order to seek to obtain a competitive edge against their competitors<sup>148</sup>.

Tietje and Lehmann argue, however, that though harmonisation should be further pursued, “*regulatory competition based on a sound international framework of cooperation and coordination is central for successful financial regulation and supervision*”<sup>149</sup>. They argue that there cannot be a one-size-fits-all which will apply to all states and which will be perfectly adopted by all states, particularly in light of the “*domestic embeddedness*” of financial products and markets<sup>150</sup>. These authors argue that there always needs to be an equilibrium between strengthening regulation and supervision on the one hand, and the essential freedom of financial markets on the other<sup>151</sup>. Similarly, this thesis argues that since states still seek to act out of self-interest, and still tacitly adopt a competitive approach, it would be desirable for regulatory competition to be embraced by states and for the regulatory framework to recognise this, particularly since a regulatory competitive framework would give rise to flexible regimes and efficient regulation.

The main criticism towards having a regulatory competitive environment is that it is claimed that this may lead to a “*race to the bottom*”<sup>152</sup>. This may also be due to the fact that given the ease of movement of industry players from one jurisdiction to another, this can generate pressure on individual jurisdictions to lower domestic regulatory standards, as industry players threaten to move to other jurisdictions if their requests are not taken on board, knowing that this may negatively impact investment and employment in that particular jurisdiction<sup>153</sup>. Furthermore, states are disincentivised from introducing stricter laws and regulations since this may similarly lead to outflows of business to other jurisdictions<sup>154</sup>. Thus, as states tweak their laws in order to keep or obtain a competitive edge over competing states, this may turn into a vicious cycle where states act in response to each other’s acts leading them to ignore the main focus of

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<sup>148</sup> Avgouleas (n 11) 355.

<sup>149</sup> Christian Tietje and Matthias Lehmann, *The Role and Prospects of International Law in Financial Regulation and Supervision* (Journal of International Economic Law, Vol. 13, Issue 3, 2010) 663, 669.

<sup>150</sup> *ibid* 663, 668 – 669.

<sup>151</sup> The authors argue that this is possible by having international regulatory supervision and coordination; Tietje and Lehmann (n 149) 664.

<sup>152</sup> Pan (n 110) 813; Wai (n 45) 255 – 256.

<sup>153</sup> Wai (n 45) 254 – 255, 258.

<sup>154</sup> Black (n 75) 9.

regulation, which should be that of ensuring the safety and soundness of the financial system<sup>155</sup>.

On the other hand, however, Pan argues that the risk of regulatory agencies discarding their responsibilities in order to provide for a competitive environment (and hence leading to a “*race to the bottom*”) is exaggerated<sup>156</sup>. He argues that this is also due to the fact that financial entities do not exist alone in the financial industry, and both consumers of financial services as well as investors seek regulation in order to give them confidence in the instruments they will be consuming and investing in respectively<sup>157</sup>.

### **2.2.2 Influences on Transnational Regulatory Bodies**

Notwithstanding the above decision-making structures, there also are other factors which play an important role in both the promulgation of transnational laws and transnational regulatory laws as well as the settling of such laws, which influences may affect each of the decision-making structures considered in Section 2.2.1. The three influences considered here are those of hegemony; regulatory capture; and domestic or cultural embeddedness.

#### **2.2.2.1 Hegemony**

A review of the relevant literature shows that hegemony is considered as being one of the main pre-conditions for international harmonisation of laws and international cooperation to take place, with regulatory cooperation and consequent harmonisation only taking place where this would be favourable to hegemonic jurisdictions<sup>158</sup>. Verdier noted that in transnational regulatory networks, national regulators typically adopt stances which reflect or further their own national interests, notwithstanding that transnational networks should be used to establish solutions to common problems across borders<sup>159</sup>. Though hegemonic influences may be present whether the structures of interaction adopted are hierarchical, cooperative, competitive or whether regulatory networks are used, the main effect of hegemonic influences can be seen in cooperative environments and when managed networks are used. When states resort to regulatory competition each state acts independently from another, whilst competing on regulation by responding to regulation introduced by other states.

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<sup>155</sup> Pan (n 110) 813.

<sup>156</sup> *ibid.*

<sup>157</sup> *ibid.*

<sup>158</sup> Quaglia (n 57) 429.

<sup>159</sup> Verdier 2009 (n 10) 142.

When hegemonic influences are present (particularly in transnational regulatory networks), rules are primarily proposed by hegemonic jurisdictions in light of their domestic preferences or aims notwithstanding that these might be framed as being beneficial for the whole transnational network<sup>160</sup>. It has therefore been suggested that cooperation in transnational regulatory networks often leads to conflicts between states, as new standards are bound to have distributive consequences, and it has therefore been recognised that conflicts would generally tend to be resolved in favour of developed countries which would typically be members of such networks<sup>161</sup>. Quaglia has recognised that as transnational regulatory agencies form in order to work towards harmonisation, international rules or standards will lead to winners and losers, with the former having competitive advantages<sup>162</sup>.

When considering the Basel Accords, one should note that the US and the UK were both eager to introduce capital requirements as from the 1980s, particularly in light of their concern about competitive equity in light of the expansion of Japanese banks, with hegemonic influences therefore clearly being present in the development of the Basel Accords<sup>163</sup>. On the other hand, it has also been argued that whilst Basel I was particularly influenced by the US and the UK, Basel III was more balanced between the interests of the US as against those of Continental Europe, possibly also in light of the increased unification of laws between members of the EU (particularly following the financial crisis)<sup>164</sup>. Nevertheless the Basel Accords have also been considered to have been introduced through what is at times referred to as “*regulatory imperialism*”, given that they were agreed to by developed countries, and with these international standards then also affecting other jurisdictions which would not have been involved in the promulgation of these standards<sup>165</sup>.

#### **2.2.2.2 Regulatory Capture**

Another element which impacts the actions of states and their national regulators is that of regulatory capture, with this being present irrespective of the structures of interaction adopted. Regulatory capture occurs when private entities push for and lobby in favour of harmonisation in order to pursue their own self-interests<sup>166</sup>. Regulatory

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<sup>160</sup> See: Verdier 2009 (n 10) 137.

<sup>161</sup> Avgouleas (n 11) 354, 362; Verdier 2009 (n 10) 115, 163.

<sup>162</sup> Quaglia (n 57) 429.

<sup>163</sup> See: Hyoung-kyu Chey (n 122) 28 – 32.

<sup>164</sup> Quaglia (n 57) 437; Verdier 2009 (n 10) 134 – 136.

<sup>165</sup> Barr and Miller (n 112) 20.

<sup>166</sup> Quaglia (n 57) 430.

capture (at times also referred to as “*agency capture*”) has been defined as “*favorable treatment of the regulated by the regulator*”<sup>167</sup>.

Lobbying by private entities may encourage regulators to act according to the interests of these private parties, and with these private interests also possibly encouraging harmonisation of laws in light of cross-border operations which they may have. Regulatory capture also suggests that in light of ongoing dealings between private entities and regulators, the latter may seek to promote solutions to the problems faced by the industry as regulators and private parties understand each other better. This has however been criticised by authors who have been of the view that the sources of both “*power*” and “*preferences*” on the global stage are held by domestic regulatory institutions rather than with the industry and that regulatory capture can therefore only have limited application in transnational laws and transnational regulatory laws<sup>168</sup>. Nevertheless Quaglia has shown that private interests and lobbying have also played a part in both the formulation of Basel I as well as in Basel III, with banks seeking to influence laws in order to rectify competitive disadvantages they might have had<sup>169</sup>. Furthermore, Tsingou has explained that Basel II “*can be interpreted as the perfect example of regulatory and supervisory capture*”<sup>170</sup>.

Regulatory capture has at times been criticised in light of seemingly paving the way for deregulation or less strict interpretation of certain regulatory requirements, as happened in the US prior to the financial crisis, particularly when top posts of regulatory agencies were given to people coming from the industry (though such persons are many times lauded for their ability to understand the industry and how this works)<sup>171</sup>. On the other hand, regulatory capture may also have positive influences in enhancing an agency’s legitimacy, particularly when regulators develop a feeling of “*affinity*” with the regulated in light of finding themselves in common circumstances with the regulated, possibly sharing a common background and a similar outlook<sup>172</sup>.

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<sup>167</sup> Julia Black, *New Institutionalism and Naturalism in Socio-Legal Analysis: Institutional Approaches to Regulatory Decision Making* (Law & Policy, Blackwell Publishers Ltd, January 1997) 78.

<sup>168</sup> Quaglia (n 57) 430.

<sup>169</sup> *ibid* 440.

<sup>170</sup> Tsingou (n 17) 142.

<sup>171</sup> Timothy A Canova, *Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model* (Harvard Law & Policy Review, Vol. 3, 2009) 384 – 385.

<sup>172</sup> Black (n 167) 78.

### **2.2.2.3 Domestic Preferences, Domestic Embeddedness and Cultural Embeddedness**

Transnational regulatory laws are agreed to at an international or transnational level and need to be implemented into national laws by national regulatory agencies in order to be given effect. It is therefore argued that the preferences of national regulatory agencies, as well as the particular legal framework within which they operate (and within which the transnational regulatory laws will need to be implemented) will influence the results which transnational regulatory laws will have in different jurisdictions. Domestic preferences are also bound to affect the ways in which international standards are implemented, interpreted and enforced notwithstanding the different structures of interaction adopted at a transnational level.

Thus, Riles has argued that though the intention of transnational regulatory bodies and members thereof is to displace national laws by global financial laws, this is far from what happens in reality<sup>173</sup>. She notes that as states commit to revise their national laws and regulations in order to comply with international standards, a number of issues remain unresolved and subject to implementation by national regulators using their own discretion<sup>174</sup>. Furthermore, she also argues that laws and regulations promulgated at a national level often ignore the way in which these are to fit in with transnational regulatory laws which may have been promulgated by international institutions or by transnational regulatory networks<sup>175</sup>.

Therefore, an important consideration for transnational regulatory laws to be properly adopted and enforced across jurisdictions, is that transnational regulatory laws need to be in synchronization with the agendas of the different national regulators which would be tasked with adopting, implementing and enforcing such regulatory laws. This has also been noted by Hyoung-Kyu who argues that “*cosmetic compliance*” or “*compliance failure*” is more likely to take place when a particular international regulatory standard is low on a national regulator’s agenda, whilst full compliance is more likely to be high

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<sup>173</sup> Riles (n 46) 78 – 79; Moschella and Tsingou have also noted how though various regulatory reforms, following the global financial crises were based on “*soft-law*”, the varying domestic financial markets; regulatory structures; existing national laws; and different organisational capacities of national regulators; give rise to the risk of transnational regulatory reform being uneven and only being partially adopted in certain jurisdictions; See: M. Moschella and E. Tsingou, *Great Expectations, Slow Transformations: Incremental Change in Post-Crisis Regulation* (ECPR Press, 2013) 209.

<sup>174</sup> Riles (n 46) 78 – 79.

<sup>175</sup> *ibid.*



when the national regulator's agenda resonates with that of the international regulatory standard<sup>176</sup>.

The problem of "*cosmetic compliance*" or "*compliance failure*" can also be assimilated with concepts applied by Black when discussing "*New Institutionalism*" and the limited extent to which law affects decision-making in scenarios where laws are given effect to through regulation which would have been introduced by regulators at a national level<sup>177</sup>. In Black's view the influence of "*law*" in such circumstances is limited, as the specific preference of regulators becomes very important given that they determine how to apply specific laws according to their preferences. The concepts put forward by Black become very relevant also when considering transnational regulatory laws, as transnational regulatory laws are only soft-law in nature, and national regulators are tasked with implementing and enforcing transnational regulatory laws. Therefore, in the same way as with regulation (within a nation state), regulators will also adopt transnational regulatory laws according to their own preferences and requirements, and according to the standards they consider appropriate.

In order to seek to eliminate preferences of national regulators, the Basel Accords, have, since the adoption of Basel II and Basel III, become very detailed and prescriptive as they seek to ensure the streamlining of rules<sup>178</sup>. The presumption adopted by the drafters of the Basel Accords thus seems to have been that detailed rules are essential in order for there to be a uniform playing-field and for uniform adoption across jurisdictions. Nevertheless, this has resulted in states being involved in heavy negotiations leading up to both Basel II and Basel III, as the states involved in the drafting of these standards sought to adopt their national preferences in the texts which were agreed to<sup>179</sup>. Needless to say, however, both individual states as well as the industry have still

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<sup>176</sup> Hyoung-kyu Chey (n 122) 14.

<sup>177</sup> Black (n 167).

<sup>178</sup> See: Eilis Ferran and Kern Alexander, *Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board* (University of Cambridge, Legal Studies Research Paper Series, Paper No. 36/2011, June 2011) 6 <[https://www.researchgate.net/profile/Kern\\_Alexander/publication/228147413\\_Can\\_Soft\\_Law\\_Bodies\\_be\\_Effective\\_Soft\\_Systemic\\_Risk\\_Oversight\\_Bodies\\_and\\_the\\_Special\\_Case\\_of\\_the\\_European\\_Systemic\\_Risk\\_Board/links/0c96052fcd3deab5b9000000/Can-Soft-Law-Bodies-be-Effective-Soft-Systemic-Risk-Oversight-Bodies-and-the-Special-Case-of-the-European-Systemic-Risk-Board.pdf](https://www.researchgate.net/profile/Kern_Alexander/publication/228147413_Can_Soft_Law_Bodies_be_Effective_Soft_Systemic_Risk_Oversight_Bodies_and_the_Special_Case_of_the_European_Systemic_Risk_Board/links/0c96052fcd3deab5b9000000/Can-Soft-Law-Bodies-be-Effective-Soft-Systemic-Risk-Oversight-Bodies-and-the-Special-Case-of-the-European-Systemic-Risk-Board.pdf)> accessed 14 June 2017.

<sup>179</sup> Verdier 2009 (n 10) 136, 141; Schooner Heidi Mandenis, and Taylor Michael W., *Global Bank Regulation: Principles and Policies* (Elsevier, 2010) 168; Quaglia (n 49) 436 – 437; Julia Black, *Learning from Regulatory Disasters* (LSE Law, Society and Economy Working Papers 24/2014, London School of Economics and Political Science) 7 <<http://ssrn.com/abstract=2519934>> accessed 10 January 2015.

managed to find ways through which the prescriptive requirements arising from the Basel Accords can be avoided, such as through the adoption of alternative financing mechanisms (as will be discussed in further detail in Chapter 3), and by only having cosmetic compliance with the Basel Accords.

Furthermore, as new requirements have been added to the Basel Accords in order to cater for the specificities of certain states, regulators of other states which may not have had the same concerns, or which may have even been of a different view to the states promoting certain amendments, may not have the necessary incentives to promote the implementation of the agreed texts. Black has highlighted that<sup>180</sup>:

*[t]here can be as many detailed rules as lawyers want to write, but if those responsible for enforcing them do not understand the activity that they are regulating, nor the rules that are in place, then it does not matter what form the rules take, they will be un-enforced.*

Thus, despite the very detailed rules established in the Basel Accords, national regulators were given the task of implementing these “soft” rules, and providing national regulatory oversight over the industry, notwithstanding that certain aspects of these transnational regulatory laws may not be in their national regulatory interest.

When considering transnational regulatory laws, and particularly the Basel Accords, it is important to keep in mind the main backdrop of political intervention which influenced the negotiations on the text of the Basel Accords<sup>181</sup>, and with these influences also being present on implementing and enforcing these international standards. Verdier has argued that transnational regulatory networks are “[f]ar from being removed from domestic politics, regulators are tied to them by multiple channels of accountability and incentives structures that generally outweigh their loyalty to global interests”<sup>182</sup>. He therefore contends that this does not imply that transnational regulatory networks cannot pursue collective aims, but, rather one should recognise that these transnational regulatory networks are also subject to clashes of state interests which may hinder international cooperation<sup>183</sup>. Hyoun-Kyu similarly states that even when states are willing to comply with international standards such as the Basel Accords, “actual

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<sup>180</sup> Julia Black, *Paradoxes and Failures: ‘New Governance’ Techniques and the Financial Crisis* (The Modern Law Review, Vol. 75, Issue 6, 2012) 1041.

<sup>181</sup> Verdier 2009 (n 10) 162.

<sup>182</sup> *ibid.*

<sup>183</sup> *ibid.*

*compliance outcomes, are affected by other domestic factors as well, and involuntary compliance failure can as a result sometimes arise*<sup>184</sup>.

Furthermore, and notwithstanding the adoption of transnational laws (and hence also transnational regulatory laws such as the Basel Accords), the proper functioning of a law will need to be seen also in conjunction with a number of social factors which will influence the implementation of any such law (also referred to as “*domestic embeddedness*”)<sup>185</sup>. Cranston observes that insofar as reforms do not take into account the proper context, “*the workings of the law will not be properly understood, and efforts at reform will be misguided*”<sup>186</sup>. Problems may not necessarily lie in established law or procedures, but, rather, these may arise in the way a law is enforced or how this operates in practice<sup>187</sup>. Similarly, Ferran has also argued that national preferences still remain even within the EU, notwithstanding the continuous harmonisation process of laws, such that this continues to affect further harmonisation of financial regulation<sup>188</sup>. The success of transnational laws and transnational regulatory laws will therefore depend on the resonance which such laws find with the legal principles operating at national levels<sup>189</sup>.

The differences between different states, and how realistically possible it is to transplant law into different states has been the subject of diverging views, with authors such as Kahn-Freund arguing that though possible, it is very difficult for law to be transplanted, and with other authors, such as Watson arguing that legal transplantation can readily be made<sup>190</sup>. Cranston, therefore argues that ultimately, as commercial activity is bound to go on, transnational laws can be implemented by different states, though the issue remains as to whether this becomes a “*living law*” or otherwise<sup>191</sup>. He states that transnational laws are bound to change through their use, once these transnational laws are interpreted and applied at a national level, in conjunction with other laws aside which they would have to operate<sup>192</sup>.

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<sup>184</sup> Hyoungh-kyu Chey (n 122) 3.

<sup>185</sup> Cranston (n 47) 612.

<sup>186</sup> *ibid.*

<sup>187</sup> *ibid* 612 – 613.

<sup>188</sup> Eñlis Ferran, ‘Crisis-driven Regulatory Reform: Where in the World is the EU Going?’ in Eñlis Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press, 2012) 36 – 37.

<sup>189</sup> Cranston (n 47) 599.

<sup>190</sup> *ibid* 614.

<sup>191</sup> *ibid* 615.

<sup>192</sup> *ibid.*

Domestic embeddedness<sup>193</sup> invariably limits the possibility of there being complete harmonization of transnational laws or transnational regulatory laws. Even in the context of transnational laws such as Treaties, where the principle of primacy of such Treaties, as well as the autonomous interpretation principle play a fundamental role, differences as a result of domestic embeddedness arise. Domestic preferences have also been discussed by Havel and Mulligan who have similarly argued that Treaties are still subject to varying interpretations at national level, particularly where Treaties, such as the CTC, reach “*many discrete areas of what has heretofore been the preserve of local rules within national legal systems, such as registration, priority rules, bankruptcy and enforcement remedies*”<sup>194</sup>. They therefore argue that the “*empirical reality is that the integration process is never seamless*” and that “[v]essels of legal uniformity like the CTC instead crash against the shores of national legal systems, emerging less than perfectly intact”<sup>195</sup>. Treaties may thus still be subject to “*progressive ‘renationalization’*” particularly since the behaviour of domestic actors becomes responsible for the interpretation and enforcement of the said Treaties<sup>196</sup>.

Wool and Jonovic have identified four main circumstances under which Treaties may not obtain primacy over national law, from a practical perspective, essentially being: due to insufficient implementation action; due to the operation of adverse hierarchical rules (such as *lex posteriori* or *lex specialis*); when issues of public law arise; as well as when

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<sup>193</sup> The term “*domestic embeddedness*” used here has similarities to the “*embeddedness*” concept used by Ruggie, though this term is here (and in the literature referred to above) used differently. Polanyi and Ruggie’s main concern was the way markets work in practice and saw social relations as being “*embedded*” in the markets such that markets needed to adapt in order to cater for the social consequences which they may bring about. Though the latter form of “*embeddedness*” may be another reason as to why divergences between the implementation of international standards differ between States (particularly in light of the soft-law nature of international standards), the focus of this Section is mainly that one needs to see transnational regulatory law within a context and with certain biases already present in the law which may help or hinder the implementation of international standards when such transnational regulatory laws get to be implemented in individual nation States. Therefore this Section does not focus on the fact that particular social action may promote the adoption or otherwise of international standards and be active actors therein, but that rather one needs to consider that transnational regulatory laws operate within a context of a national framework, and are adopted by national regulators, which may have their own inherent biases and prejudices. See: John Gerard Ruggie, *International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order* (International Organization, Volume 36, Issue 02, March 1982); Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Beacon Press, 1971).

<sup>194</sup> Brian F Havel and John Q Mulligan, *The Cape Town Convention and the Risk of Renationalization: A Comment in Reply to Jeffrey Wool and Andrej Jonovic* (Cape Town Convention Journal, November 2014) 83.

<sup>195</sup> *ibid* 84.

<sup>196</sup> *ibid*.

there might exist conflicts between Treaties and Constitutional laws<sup>197</sup>. They however also argue that assuming primacy of Treaties is a simplistic assessment, particularly as Treaties become more complex instruments and move into areas of law such as those of property rights, insolvency and dispute resolution<sup>198</sup>. Therefore, as these issues arise in the more formal structure of Treaties, they are bound to be even more marked and cause further issues in transnational regulatory laws which are only bound together by “*soft laws*”.

Apart from domestic preferences giving rise to undesirable influences affecting the different structures of interaction seen above, constraints in the implementation of transnational regulatory laws also arise due to intrinsic differences in national laws which may hinder the achievement of similar results even in the event that the same transnational regulatory laws were to be applied in the same way across borders. Two main restrictions on the Basel Accords achieving the same results in different jurisdictions (which will be considered in Chapters 6 and 7), are the varying laws on security interests and the laws on insolvency which different jurisdictions adopt. Though much has been written about the need of transnational laws to operate within contexts of national rules, it probably still comes as no surprise that the proponents of the Basel regime have just sought to omit any reference to the insolvency laws of underlying jurisdictions, and the impacts that these may have on industry participants. This may be due to the fact that harmonisation of insolvency laws have at most only relied on conflict of law measures (such as EC Regulation 1346/2000 (the “**Insolvency Regulation**”) and Regulation 2015/848 on Insolvency Proceedings (the “**Recast Insolvency Regulation**”))<sup>199</sup>, with harmonisation of insolvency laws between jurisdictions only being considered as something which “*can only every be a very long-term project*”, and which would require “*detailed legal reform at a domestic level*” given that differences between different states reflect “*deep-seated cultural divergences*”<sup>200</sup>.

## 2.3 The Theory of Recursivity

The main focus of the above sections of this Chapter has been the way in which transnational laws and transnational regulatory laws come into being, the ways in which entities forming part of transnational institutions and transnational regulatory networks

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<sup>197</sup> Wool and Jonovic (n 61) 67 – 68, 72 – 74.

<sup>198</sup> *ibid* 67.

<sup>199</sup> Council regulation (EC) No 1346/2000 on insolvency proceedings [2000] OJ L 160/1 (Insolvency Regulation); EU Regulation 2015/848 of the European Parliament and of the Council of on insolvency proceedings [2015] OJ L 141 (Recast Insolvency Regulation).

<sup>200</sup> Black and Rouch (n 49) 218 – 219.

interact, and the different influences which may exist on transnational regulatory networks. Transnational legal orders are however also subject to iterative cycles of change, of settling and unsettling, and of alignment and misalignment, up till the point when there is settling and concordance in and amongst each of the transnational, national and local spheres<sup>201</sup>.

When considering transnational regulatory laws, such as the Basel Accords, one must also consider the settling process and the ways through which these transnational instruments are adopted in different jurisdictions. This process will necessarily be affected by the “*influences*” referred to above (i.e. hegemony, regulatory capture, and domestic embeddedness). The settling process may however vary from one jurisdiction to another and may also vary according to the particular transnational instrument which would be in the process of being adopted.

Halliday and Shaffer have considered the recursive process through which “*legal norms are developed, conveyed and settled transnationally, integrating both bottom-up and top-down analyses*”<sup>202</sup>. Halliday and Carruthers have shown how globalization has led to the following cycles<sup>203</sup>: recursive cycles of lawmaking at the national level; iterative cycles of norm making at the global level; and cycles at the intersection of the processes which take place at the national and at the global level, where the national experiences influence global norm making, and where global norms influence or constrain national lawmaking. Having considered the development of the Basel Accords throughout the years in Section 2.1.1, this thesis adopts the recursivity theory in order to analyse the settling (or otherwise) of the Basel Accords within different states.

Halliday and Carruthers have identified “*four mechanisms that drive recursive processes and that shape patterns of settlement of transnational legal norms in national and local settings*”<sup>204</sup>. They argue that these mechanisms “*drive forward these cycles of reform until the inherent tensions within them are resolved and normmaking settles*”<sup>205</sup>. These four mechanisms are “*the indeterminacy of law, contradictions, diagnostic struggles, and*

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<sup>201</sup> Halliday and Shaffer (n 12) 513. See also: Gregory Shaffer, *Transnational Legal Process and State Change* (Journal of the American Bar Foundation, Law & Social Inquiry, Vol 37 Issue 2) 238 – 239 <<http://onlinelibrary.wiley.com/doi/10.1111/j.1747-4469.2011.01265.x/full>> accessed 12 December 2016.

<sup>202</sup> Halliday and Shaffer Introduction (n 12) 3.

<sup>203</sup> Halliday and Carruthers (n 12) 1135, 1136, 1187; Halliday (n 12) 263.

<sup>204</sup> Halliday and Shaffer Introduction (n 12) 38.

<sup>205</sup> Halliday (n 12) 263; Halliday and Shaffer Introduction (n 12) 38; See also: Halliday and Carruthers (n 12) 1135.

*actor mismatch*<sup>206</sup>. They consider that the recursive process starts off through “*diagnostic struggles*”, whereby actors facing a particular problem seek other actors in order to work together towards a common solution<sup>207</sup>. They note how these actors may be in competition with or have differing views from other actors who may contest their diagnosis or who may diagnose the problem in competing ways<sup>208</sup>. Those actors who diagnose the problem differently from the prevailing view, will probably be excluded from the formulation of the particular transnational law, but will probably resist its implementation at later stages<sup>209</sup>.

These authors continue by noting that there will also be “*actor mismatch*”, as certain actors who “*wield power in the national and local implementation of transnational legal norms*” do not necessarily manage to wield the same power at a global level<sup>210</sup>. Halliday and Shaffer therefore note how<sup>211</sup>:

*if domestic actors integral to the implementation of a transnational legal norm are not represented in domestic lawmaking, they will be less invested in the law's implementation and may effectively veto it in practice, potentially triggering a new cycle of legal normmaking to resolve the differences.*

The third mechanism referred to by Halliday and Carruthers which drives recursive cycles, is that of “*contradictions*”, whereby legal norms which may have been negotiated at the transnational level may contain “*unresolved ideological clashes*”, which might also give rise to “*institutional contradictions*”, as the solution adopted at a transnational level might result from conflicting ideologies which might have been poorly resolved at the transnational level, with parties therefore possibly agreeing to only partial or temporary solutions<sup>212</sup>. This lack of clarification leads to the possibility of different interpretations being adopted, leading to inconsistencies and ambiguities, such that different actors may adopt varying approaches on the implementation and enforcement of the particular law, and with these contradictions still needing to be clarified through further recursive cycles<sup>213</sup>.

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<sup>206</sup> Halliday and Carruthers (n 12) 1148; Halliday (n 12) 263, 277.

<sup>207</sup> Halliday and Shaffer Introduction (n 12) 38.

<sup>208</sup> *ibid*; Halliday (n 12) 278 – 279.

<sup>209</sup> Halliday and Carruthers (n 12) 1150 – 1151.

<sup>210</sup> Halliday and Shaffer Introduction (n 12) 38.

<sup>211</sup> *ibid* 39; See also: Halliday and Carruthers (n 12) 1152; Halliday (n 12) 277.

<sup>212</sup> Halliday and Shaffer Introduction (n 12) 39; Halliday and Carruthers (n 12) 1149; Halliday (n 12) 280.

<sup>213</sup> Halliday and Carruthers (n 12) 1149 – 1150; See also: Shaffer (n 201) 251.

Lastly, the norms created at the transnational level might be “*indeterminate*”, as a result of the linguistic limits, the costs which might be involved in seeking to create detailed laws which cater for all scenarios, or possibly “*because actors decide to gloss over differences with vague language to conclude an agreement*”<sup>214</sup>. These internal contradictions therefore lead to differences in implementation across jurisdictions, “*undermining the aims of a TLO’s promoters*”<sup>215</sup>. This indeterminacy is bound to lead to recursive cycles as those actors who would not have been part of the drafting process (or who would not have been successful in promoting their views) try to adopt interpretations which suit them, whilst the promoters of the same text seek to amend national laws in order to seek to reach their original aims<sup>216</sup>.

Halliday and Shaffer note how as a result of transnational recursivity theory one can see how “*black letter law seldom is implemented as its designers intended, and frequently it is resisted, subverted, or neutralized in practice. It helps explain not only the existence of the gaps but also how they expand or close over time*”<sup>217</sup>. Recursivity theory thus stipulates that legal change occurs through “*repeated iterations*” which take place transnationally, nationally and locally<sup>218</sup>. Halliday and Carruthers note how cycles are particularly driven by ambiguity and by actors who would have been excluded from the governing statutory law within which change occurs – as these factors create resistance to the established global norms, recursive cycles take place until contradictions are resolved, consensus is reached, settling occurs, or an underlying cause fades away<sup>219</sup>. Furthermore recursive cycles may also be triggered by economic, political and social contradictions which may produce disturbances or triggering events<sup>220</sup>. Recursivity therefore “*is located at the nexus of endogenous and exogenous exchanges between nation-states and international organizations*”, with the recursive episodes being “*a significant site for the mediation of exchanges between the global and the national*”<sup>221</sup>.

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<sup>214</sup> Halliday and Shaffer Introduction (n 12) 40; Halliday (n 12) 281.

<sup>215</sup> Halliday and Shaffer Introduction (n 12) 40.

<sup>216</sup> Halliday and Carruthers (n 12) 1149.

<sup>217</sup> Halliday and Shaffer Introduction (n 12) 40.

<sup>218</sup> Block-Lieb and Halliday (n 12) 101 – 102; See also: Halliday (n 12) 274 – 275.

<sup>219</sup> Halliday and Carruthers (n 12) 1145, 1147.

<sup>220</sup> *ibid* 1145.

<sup>221</sup> *ibid* 1192.



### 2.3.1 Identifying the Actors in the Basel Accords' Recursive Process

When considering transnational regulatory laws such as the Basel Accords, particular importance needs to be given to the “actors” which are establishing the transnational regulatory law, and which need to help in its settling process. Though actors include states, international professional associations, epistemic communities, transnational advocacy networks, social movements, transnational economic interest groups, non-governmental organizations, and possibly also religious groups<sup>222</sup>, the three main actors which are involved in the Basel Accords' recursive process, are the national regulators which come together to form an “*international community*”, individual nation states (acting alone), and the industry. It will be argued that a transnational regulatory law such as the Basel Accords will only be successful, effective and considered to be legitimate, if each of these three actors would have bought-in to what the particular transnational regulatory law would be trying to achieve. Verdier has noted how these three actors (referred to by Verdier as “*regulators, banks, and politicians*”) have been in a “*protracted war*” on the implementation of the Basel Accords (with Verdier's main focus being on Basel II)<sup>223</sup>.

Of particular interest, however, is the role of nation states. When considering “law” generally, and before the importance which is now being given to transnational law and transnational regulation, the state had been considered as the sole source of law. On the other hand, however, on considering transnational law and transnational regulatory law, the role of the state changes from being the sole source of law, to being one of the main actors, and with states also acting out of self-interest<sup>224</sup>. Raustiala has therefore argued that one needs to go beyond the considerations provided by Goldsmith and Posner (through their rational choice theory) as one needs to drop the “*state-as-unitary-actor assumption*” in favour of “*a more realistic and complex understanding of the state and its component parts*”<sup>225</sup>.

Whilst “[n]ation-states remain central”<sup>226</sup> to transnational legal orders, “*they do not define the territorial boundaries of legal ordering*”<sup>227</sup>, and therefore states find

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<sup>222</sup> Halliday (n 12) 266.

<sup>223</sup> Verdier 2012 (n 10) 8.

<sup>224</sup> See also: Peer Zumbansen, *The Ins and Outs of Transnational Private Regulatory Governance: Legitimacy, Accountability, Effectiveness and a New Concept of “Context”* (German Law Journal, Vol 13, No 2, 2012) 1280 – 1281.

<sup>225</sup> Kai Raustiala, *Refining the Limits of International Law* (Georgia Journal of International and Comparative Law, Vol 34, 2006) 9 – 12.

<sup>226</sup> Halliday and Shaffer Introduction (n 12) 6.

<sup>227</sup> *ibid.*

themselves needing to consider also the interests of the international community, the industry, and of other states which also consider their self-interest in the formulation of a particular transnational legal order. Nation states, however remain “*central to lawmaking, law recognition, and law enforcement*”<sup>228</sup>, notwithstanding its “*fragmentation and disaggregation...in its constituent branches and agencies*”<sup>229</sup>. Halliday has also noted that “[s]tates are primary actors in global normmaking” when considering the recursivity process<sup>230</sup>. Thus, Halliday and Shaffer both consider that there is a “*remarkable decentring of the state and its reconsideration as a crucial legal-political actor in a regulatory space marked by an interaction in between different levels of norm-making*”<sup>231</sup>.

Furthermore, the interests within a state cannot automatically be considered to be monist, but there may be various conflicting interests within a state itself. Lyngen explains that different public officials might have varying goals notwithstanding that they emanate from the same state, with the following being some of the goals which different public officials might have: promotion of investor confidence, financial stability, international competitiveness of the particular state’s financial sector, and pleasing of the different constituents (which might also include financial sector and consumer interest groups)<sup>232</sup>.

When considering “*states*” and the various interests which arise therefrom, this thesis considers the interests of “*states*” as consisting of the prevailing view which results in the state of affairs of the state at a particular moment in time. It is therefore here assumed that if a jurisdiction would only have adopted the Basel Accords “*cosmetically*”, or “*partially*”, then the prevailing interests in that current state would have led to such limited adoption. In accordance with the recursivity model, this prevailing view would have only come as a result of various iterative cycles within the nation state itself, and may also be subject to change from time to time<sup>233</sup>. As will be discussed in further detail in the next Section, each actor acts out of self-interest, leading to the Basel Accords to continue to be in a continuous recursive process, without there yet being proper “*settling*”.

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<sup>228</sup> *ibid* 13.

<sup>229</sup> *ibid* 23.

<sup>230</sup> Halliday (n 12) 266.

<sup>231</sup> Zumbansen 2016 (n 9) 20.

<sup>232</sup> Lyngen (n 76) 521 – 522.

<sup>233</sup> See also: Halliday and Carruthers (n 12) 1191 – 1192.

### 2.3.2 Actors Acting out of Self-Interest

Lyngen argued that regulatory coordination through transnational regulatory networks, as in the case of the Basel Accords will have a “*distributive effect, with some states gaining at the expense of others*”<sup>234</sup>. She notes that as a result of the differences in the financial sectors of different jurisdictions, implementation of the Basel Accords in different states will give rise to “*distinct costs of implementation for each state and implications for the international competitiveness and profitability of that state’s regulated sector*”<sup>235</sup>. Thus, whilst certain states stand to benefit from a global regulatory standard, others will face “*a disproportionate amount of the costs*”, and states which may have had a competitive advantage over other states may stand to lose such competitive advantage<sup>236</sup>.

As a result, Lyngen argues that the regulatory discretion afforded in the Basel Accords, though required in light of differences in the domestic regulated sectors, and also required in order to encourage adoption of the Basel Accords, “*creates opportunities for regulators to establish rules that favor their state’s institutions*”<sup>237</sup>. This distributive effect has also been highlighted by Brummer when considering the elements of soft law in international financial regulation<sup>238</sup>. Brummer thus notes how “[o]ne rule may have, in short, significant positive effects in one country, whereas in another, the implications may be far from beneficial”, whilst going on to list “*capital adequacy*” as the “*possible canonical example*” of this<sup>239</sup>. He also argues that coordination in transnational law and regulation is only likely to arise where members have high incentives to cooperate and where adjustment costs are small<sup>240</sup>.

Zumbansen has also noted how one can clearly see parallels between the “*interests*” at stake (in both national and international contexts), and the loss of coherence, unity and universality of the Rule of Law within a globalized framework<sup>241</sup>. He therefore argues that when considering transnational law as a methodological approach one should “*start asking (again) the hard question as to who does what how and in whose interests*”<sup>242</sup>.

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<sup>234</sup> Lyngen (n 76) 522.

<sup>235</sup> *ibid.*

<sup>236</sup> *ibid.*

<sup>237</sup> *ibid* 528.

<sup>238</sup> Brummer (n 102) 635.

<sup>239</sup> *ibid.*

<sup>240</sup> Brummer (n 100) 303.

<sup>241</sup> Zumbansen 2016 (n 9) 36.

<sup>242</sup> *ibid* 40.

Throughout this thesis it is argued that each of the different actors, as identified above, act out of self-interest, and it is therefore essential in order for there to be concordance in the way in which the Basel Accords are adopted, implemented, and enforced for the interests of each of the actors to be taken into consideration, therefore also resulting in the transnational regulatory network also being considered as “*legitimate*” in the eyes of each of these actors. This is also in accordance with the analysis made by Block-Lieb and Halliday who argue that concordance within a transnational legal order takes place more quickly when “*it sequences from the “bottom up” or with the “bottom” fully engaged in reform efforts occurring at the “top” transnational or international circles*”<sup>243</sup>. Shaffer has also noted how self-interest can lead to the acceptance or rejection of transnational legal norms, and that as a result of self-interest transnational legal norms may be used or changed for purposes that were not contemplated by the promoters of those transnational norms<sup>244</sup>.

Part III of this thesis argues that one of the major flaws of the Basel Accords has been the lack of economic analysis by its drafters. This is due to the assumption which seems to have been adopted by the “*international community*” that transnational regulatory standards can be applied uniformly across borders, notwithstanding the distributive effects which such transnational regulatory standards may have on states, and notwithstanding the costs which may be incurred by the industry as a result of such transnational regulatory standards.

This thesis also endorses Brummer’s view (with this being discussed in further detail in Part III) that as financing entities act out of self-interest, they increasingly move from one jurisdiction to another in order to arbitrage strict regulations across different jurisdictions. Brummer also notes how regulators compete with one another to attract capital, with this possibly even leading to dismantling of efficient regulations in hope of attracting firms<sup>245</sup>. He thus criticizes the use of soft law for international financial regulation, as he says that “[a]ssuming countries follow policies that promote the interests of their domestic firms, soft law should provide little utility as a means of making credible commitments”<sup>246</sup>. He continues by stating that when “*collaboration results in a win for some parties and a loss for others, international legal theory predicts that parties will*

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<sup>243</sup> Block-Lieb and Halliday (n 12) 101.

<sup>244</sup> Shaffer (n 201) 256.

<sup>245</sup> Brummer (n 100) 267 – 268.

<sup>246</sup> *ibid* 271.

*defect from their commitments because they are informal*"<sup>247</sup>. It is therefore here argued that a soft-law approach cannot work in a situation where the different actors act out of self-interest and where the interests of these actors vary (such as in the case of regulations which are just perceived as imposing costs on the industry).

Given the regulatory nature of the Basel Accords, one also can compare the development of the Basel Accords as a transnational regulatory law, with the development of transnational tax law, given that both impose costs on the industry and without there being any direct benefits which accrue to the industry as a result of such costs and constraints. Genschel and Rixen have noted how double tax relief gave rise to tax competition amongst jurisdictions, allowing the industry to arbitrage the system, and leading to national governments seeking to be competitive through low-tax strategies<sup>248</sup>. Though the self-interest element of different actors is possibly much more evident when analyzing international tax systems, this thesis argues that self-interest becomes an essential consideration where the particular transnational law or transnational regulation only imposes "*costs*" upon one of the actors<sup>249</sup>.

As a result of the recursive process, when states resist or reject the insertion of global norms in their domestic regimes, they compel the global normmakers to alter the transnational norms (unless the global norms agreed to are to be retained but without having the desired effect and without being able to reach their stated aims), particularly since transnational norms are most effective when they are adopted consistently across jurisdictions<sup>250</sup>.

### **2.3.3 Settlement and Institutionalization of the Basel Accords**

A transnational legal order becomes institutionalized when "*legal norms and practices converge to guide actors over what norms apply in given situations*", and the "*ultimate test*

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<sup>247</sup> *ibid.*

<sup>248</sup> Philipp Genschel and Thomas Rixen, 'Settling and Unsettling the Transnational Legal Order of International Taxation' in Terence C. Halliday and Gregory Shaffer (eds.) *Transnational Legal Orders* (Cambridge University Press, 2015) 154.

<sup>249</sup> This can easily be compared and contrasted with different types of transnational law which have developed from the "bottom" upwards, such as the ISDA Master Agreement, and the FIDIC standard agreements, which provided benefits, rather than costs, to the industry. The transnational instruments such as the ISDA Master Agreement and the FIDIC standard agreements can predominantly be classified as 'private' forms of transnational instruments, whilst transnational regulatory laws such as the Basel Accords have a predominantly 'public' nature. See also Zumbansen 2016 (n 9) regarding the classification of private and public transnational law instruments and the application of the distinction between private and public transnational law instruments.

<sup>250</sup> Halliday (n 12) 273.

*of successful institutionalization...occurs when actors behave according to a set of legal norms that they simply take for granted as being appropriate in a particular situation*"<sup>251</sup>. Settling is considered to take place at three different levels: transnational settling; national settling; and local settling<sup>252</sup>. However, settling at one level may not necessarily be in concordance with the way in which legal norms might have settled at a different level, and settled legal norms at the transnational level may vary substantially from legal norms which would have been settled at the national or at the local level<sup>253</sup>.

Block-Lieb and Halliday consider "*legal meaning*" to be stabilised and "*legal norms*" to be "*settled*" "*when the affected actors can predict each other's conduct and advice pertaining to the legal norms*"<sup>254</sup>, and that this takes place when there is a combination of one or more of the following<sup>255</sup>:

*(1) stakeholders know which norms apply to them in given situations and accept the scope of those norms; and (2) the meanings and reach of the norms become stabilized for the great majority of those engaged with them for most relevant behaviour most of the time".*

They also argue that settling and concordance is less likely to occur when, *inter alia*, "*actors developing the norms do not represent the interests of all powerful stakeholders*", as well as when "*the norms are so ambiguous, inconsistent, or excessively complicated that their meanings fail to guide action with any determinacy*"<sup>256</sup>. As will be discussed in further detail below, both of these elements are evident when considering the Basel Accords.

When considering the status of the Basel Accords, one can argue that though the Basel Accords were first established in 1988 there is yet to be proper settling of these international standards. Basel III, agreed to in December 2010 can be considered to be the "*third iteration*" of the Basel Accords<sup>257</sup>. It has however been noted that implementation of the Basel Accords in different nation states "*has always been contentious, with variations in state-level adoption*"<sup>258</sup>. This thesis argues that this has been due to ambiguity of terms in the agreed texts of the Basel Accords (as will be

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<sup>251</sup> Halliday and Shaffer Introduction (n 12) 42.

<sup>252</sup> *ibid* 43 – 44.

<sup>253</sup> *ibid* 44; Block-Lieb and Halliday (n 12) 94.

<sup>254</sup> Block-Lieb and Halliday (n 12) 90.

<sup>255</sup> *ibid*,

<sup>256</sup> *ibid*.

<sup>257</sup> Lyngen (n 76) 519.

<sup>258</sup> *ibid*.

discussed in further detail in Chapter 3); the self-interest of the different actors leading to lack of legitimacy of the Basel Accords and incentives to use regulatory arbitrage (as will be discussed in Chapters 4 and 5); as well as the domestic embeddedness problems and differences arising from the national laws within which the Basel Accords operate (as will be discussed in further detail in Part IV of this thesis). This can also be seen from the continuous revisions of the Basel Accords (and the long periods within which nation states are to comply with the agreed texts), together with the limited impact which the Basel Accords had on the 2008 financial crisis.

Helleiner has also noted how members of the G20 and of the FSB are “*facing a growing number of questions*” as to whether the standards adopted by the Basel III will be implemented or otherwise, and that “[m]any commitments made under Basel III are also controversial in Europe and the United States, and it is far from clear whether they will be introduced in full by the final deadline of 2019”<sup>259</sup>. He has also noted how developing countries “*refused to implement*” Basel II, “*implementing them partially or engaged only in “mock compliance”*”, and that the implementation challenges facing Basel III are “*even more severe*”<sup>260</sup>.

## **2.4 Conclusion**

After providing a brief background to the development of the Basel Accords, Part II of this thesis has classified the Basel Accords as a “*transnational regulatory law*” which has been formulated through “*transnational regulatory networks*”.

The different types of decision-making structures which can be adopted by transnational regulatory networks have been considered, and it is argued that whilst the BCBS primarily partakes from regulatory cooperation and network management strategies, national regulatory agencies continue to adopt regulatory competitive stances. This arises due to a mismatch in the self-interest of the main actors, which have been identified as the BCBS (through which national regulators and supervisors come together in order to form one international community), the individual nation states acting out of their own self-interest, and the industry.

Part III of this thesis will analyse further how a lack of economic analysis in drafting, adopting, implementing and enforcing the Basel Accords has continued to give rise to

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<sup>259</sup> Eric Helleiner, ‘Regulating the Regulators: The Emergence and Limits of the Transnational Financial Legal Order’ in Terence C. Halliday and Gregory Shaffer (eds.) *Transnational Legal Orders* (Cambridge University Press, 2015) 249.

<sup>260</sup> *ibid* 250.

further regulatory competition as a result of the self-interest of the individual nation states and of the industry, with this also giving rise to regulatory arbitrage, which limits the effectiveness of the Basel Accords. Hence, this thesis argues that one should recognize that regulatory competition is bound to continue to take place amongst states, and national regulators should therefore be handed over the responsibility to make sure that national laws and the industry do not abuse of the regulatory framework. It will therefore be argued that certain binding principles should move away from the soft-law approach adopted, towards the use of a binding Treaty which creates obligations between states, and which will ensure that a minimum standard can be established between different national regulators. This can however be coupled with regulatory competition on the finer details, which will also allow efficient regulation to be adopted.

This Part II further notes that transnational regulatory networks and regulatory agencies are subject to three main influences, consisting of hegemony, regulatory capture, and domestic and cultural embeddedness and domestic preferences. Part IV of the thesis will also refer to domestic embeddedness, but this will be seen in a different light – whereas this Part II considers domestic embeddedness as affecting national regulators in their decision-making, and particularly when forming part of a transnational regulatory network, Part IV will argue that differences in the underlying laws will still give rise to differences in the results of transnational regulatory laws, such as the Basel Accords, due to the underlying laws within which these transnational regulatory laws are meant to operate. Therefore whilst domestic embeddedness is here considered as an “*influence*” on the decision-making and approach adopted by national regulators (and when forming part of a transnational regulatory network), Part IV also considers domestic embeddedness as being a limitation on the transplantation of transnational regulatory laws within local regulatory frameworks.

Finally, this Chapter has also argued that the Basel Accords are yet to “*settle*” at each of the transnational, national and local frameworks, and with iterative cycles continuously taking place. This can however also be seen as a consequence of the Basel Accords and the BCBS ignoring the interests of the industry as well as of states which act in a regulatory competitive environment, such that there will continue to be tensions between what the BCBS seeks to set out as a transnational regulatory law, and how this is actually implemented in practice.



**PART III – LACK OF CONSISTENCY, LACK OF LEGITIMACY,  
AND REGULATORY ARBITRAGE**

## **Chapter 3: Applicability of the Basel Accords and the Objectives of the Basel Accords**

After having considered the Basel Accords as a form of transnational regulatory law this Chapter will consider various differences which apply in the way in which the Basel Accords have been implemented in different jurisdictions. In particular, this Chapter will show that although the Basel Accords seek to regulate “*internationally-active banks*”, there exist differences across jurisdictions both as to what the term “*bank*” and the term “*internationally-active*” mean.

This Chapter will further consider how different jurisdictions have widened the scope of the Basel Accords by applying these standards to different types of entities (namely to all types of banks, and investment firms), and that the current regulations are neither catering for continuous changes to entities which form part of the banking system, nor extended to entities which provide services which may have the same economic function as those provided by banks (shadow banks). Given that the terminology of the Basel Accords always referred to “*internationally-active banks*”, the different ways in which the Basel Accords have been implemented across jurisdictions have never been challenged, and hence continue to act as a limitation on the Basel Accords (to the extent that the Basel Accords are to be considered as the main regulatory standard for most banks, and not just for internationally-active banks).

This Chapter will also argue that the stated aims of the Basel Accords have changed along the years, such that though initially the Basel Accords sought to have an international standard which would help with having regulatory convergence across different jurisdictions, this is no longer the main aim of the BCBS, with the main focus now being on the “*soundness and stability of the international banking system*”. In fact, Chapters 4 and 5 will argue that the lack of consistency and regulatory convergence highlighted throughout this Chapter has given rise to regulatory arbitrage opportunities to the industry (such as by shifting their activities to unregulated entities), and with this, in turn, still posing a problem towards the soundness and stability of the international banking system.

### ***3.1 Varying definitions of “Banks”***

Though the Basel Accords are now considered to be the main regulatory standard for most banks in most jurisdictions, there is no common definition as to which entities these international standards are to apply. Whilst some jurisdictions have extended the

Basel Accords to all banks (and investment firms), others have only applied these international standards to “*internationally-active banks*”, as required by the Basel Accords.

Basel I identified its scope of application as setting standards of regulation for “*banks undertaking international business*”<sup>261</sup>. It also continued by specifying that “*the agreed framework is designed to establish minimum levels of capital for **internationally active banks**...[emphasis added]*”<sup>262</sup>. One of its main objectives therefore was that of reaching a “*high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among **international banks** [emphasis added]*”<sup>263</sup>.

Similarly Basel II also referred solely to “*internationally active banks*”<sup>264</sup>:

*The fundamental objective of the Committee’s work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among **internationally active banks** [emphasis added].*

Thus, though Basel II introduced much more detailed rules than Basel I, its scope of application was still specifically focused, stating that “[t]his Framework will be applied on a consolidated basis to **internationally active banks**...[emphasis added]”<sup>265</sup>. This “*Scope of Application*” remained unchanged by Basel III, which simply stated that the scope of application as set out in the Basel II framework will continue to be followed<sup>266</sup>.

It is clear that throughout the different texts of the Basel Accords the main focus has always been that of applying common regulatory standards to banks operating across borders, also referred to as “*internationally-active banks*”. Regulatory convergence

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<sup>261</sup> Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988) 2 para. 4 <<http://www.bis.org/publ/bcbs04a.pdf>> accessed 21 September 2014 (Basel I).

<sup>262</sup> See also: Basel I (n 261) 2 para. 7.

<sup>263</sup> Basel I (n 261) 1 para. 3.

<sup>264</sup> Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A revised framework* (Comprehensive Version, June 2006) 2 para. 4. <<http://www.bis.org/publ/bcbs128.pdf>> accessed 21 September 2014 (Basel II).

<sup>265</sup> *ibid* 7 para. 20.

<sup>266</sup> Basel III, 2010 (n 35) 11 para. 47.

between internationally-active banks was therefore considered as necessary in order to ensure a level playing field between these banks<sup>267</sup>.

Though the Basel Accords refer to “*internationally-active banks*”, this term is not defined in the Basel Accords notwithstanding that the Accords refer to “*banks*” and “*internationally-active banks*” on numerous occasions throughout the different texts and in their scope of application. This gives rise to definitional issues, as different states adopt differing definitions of a “*bank*” (with differences also arising within the EU, on there being incongruences between national law definitions and those adopted in EU legislative texts). Furthermore, the Basel Accords neither provide definitions as to what makes a bank “*internationally-active*” or otherwise.

The only instance where the Basel Accords seem to indicate what activities a “*bank*” should carry out can be found in Basel II, on establishing the “*Standardized Approach*” (by cross-reference to Annex 8 of Basel II). The banking activities referred to here are divided into eight business lines, consisting of<sup>268</sup>: Corporate Finance; Trading and Sales; Retail Banking; Commercial Banking; Payment and Settlement; Agency Services; Asset Management; and Retail Brokerage. These business lines are however only referred to in order to allow the calculation of the relevant capital charges of a bank using the Standardised approach, and do not provide a specific definition of a “*bank*”. Furthermore, the said “*business lines*” are very wide terms, and there is no requirement for a bank to carry out all or only some of these business lines in order to be considered as a “*bank*”.

What constitutes a “*bank*” and what makes a bank “*internationally-active*” for the purposes of the Basel Accords therefore remains unclear. Furthermore, apart from the varying definition of “*banks*” across different jurisdictions, the entities to which capital adequacy regulation (following on the Basel Accords) has been applied to in different jurisdictions has also varied significantly. Given that the Basel Accords still refer to “*internationally-active banks*” the BCBS seemingly ignore the activities of entities which are not classified as “*banks*” (notwithstanding that they may provide similar activities); whilst neither are they concerned about banks which do not have an “*international*” element (even though major jurisdictions have applied the capital adequacy regulations as deriving from the Basel Accords to all banks, whether internationally-active or otherwise).

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<sup>267</sup> Basel I (n 261) 1 para. 3; Basel II (n 264) 7 para. 20; Barth and others (n 24) 28 – 40;

<sup>268</sup> Basel II (n 264) 146.

Capital adequacy rules have historically been considered to be essential in light of the intrinsic nature of banking, whereby banks “create” money by acting as an intermediary between those who require safe-keeping of their money, and those who need to borrow money (also referred to as “maturity transformation”)<sup>269</sup>. This means that banks are never liquid enough to be able to satisfy all their depositors on demand, due to loans which a bank would have granted<sup>270</sup>. Furthermore, banks may also be negatively affected by the failure or troubles of other banks in light of the widespread interconnectedness of the banking system, thereby also giving rise to systemic risk<sup>271</sup>. This makes banks subject to bank runs should there be a loss of confidence in the said bank or in the banking system. Nevertheless, there has been no effort by the promoters of the Basel Accords to consider whether all entities which undertake liquidity and maturity transformation, and which may as a result also give rise to systemic risks, should be subject to the Basel Accords or otherwise.

This thesis will proceed by considering the different definitions of what constitutes a “bank” in the UK, the EU and the US. These jurisdictions have been selected in light of their leading roles in the financial services industry, and also in light of the particular influences they have had in the promulgation and development of the Basel Accords. As will be seen below, the main element forming the basis of all the available definitions which have been considered is that in order for the definition of “bank” to apply, there need to be “deposits” or “other repayable funds” taken from the public. This distinguishes a “bank” from other institutions which might be providing similar services to banks.

### **3.1.1 United Kingdom**

In the UK, there is no generally applicable functional definition that distinguishes “banks” from other types of financial institutions<sup>272</sup>. Different statutes define the term “bank” differently according to their specific regulatory purpose<sup>273</sup>. In the absence of a consistent basic definition of a “bank”, the Courts have sought to construct its meaning by establishing the following three essential principles:

- (i) The meaning of “banking business” can change from time to time;

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<sup>269</sup> Prasad Krishnamurthy, *Regulating Capital* (Harvard Business Law Review, Vol. 4, 2014) 13 – 14.

<sup>270</sup> *ibid.*

<sup>271</sup> *ibid* 14.

<sup>272</sup> E.P. Ellinger, E. Lomnicka, C. Hare, *Ellinger’s Modern Banking Law* (OUP, July 2011) 79.

<sup>273</sup> *ibid.*

- (ii) A financial institution that is regarded as engaging in “*banking business*” in one jurisdiction is not necessarily considered as doing so elsewhere; and
- (iii) An institution’s reputation may be important when determining whether it is a “*bank*”<sup>274</sup>.

Traditionally the meaning of “*banking business*” referred to the acceptance of money on deposit from members of the public, who thereby became customers of the bank, and the relending or reinvesting of those funds by the bank in order to make a profit<sup>275</sup>.

In *United Dominions Trust v. Kirkwood*<sup>276</sup> the Court further specified that engaging in lending does not by itself make an institution a “*bank*”, and though the acceptance of deposits remains a *necessary* condition of an institution qualifying as a “*bank*”, this activity is not considered to be a *sufficient* condition: an entity cannot qualify as a “*bank*” at common law unless it opens, on behalf of customers, current accounts operable by cheque and into which customers can pay cheques and other effects for collection (though it has been recognised that this definition may need to be updated to take into consideration more modern methods of payments which banks make use of)<sup>277</sup>. Lord Denning MR thus stated that<sup>278</sup>:

*There are therefore, two characteristics usually found in banks today: (i) They accept money from, and collect cheques for, their customers and place them to their credit; (ii) They honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly. These two characteristics carry with them also a third, namely: (iii) They keep current accounts, or something of that nature, in their books in which the credits and debits are entered.*

Furthermore, a bank should also normally possess the qualities of stability, soundness and probity, whilst evidence of an entity’s reputation as a bank may also be relevant in considering whether an institution is a “*bank*” or otherwise<sup>279</sup>. Lord Denning continued by stating “[i]n case of doubt, it is, I think, permissible to look at the reputation of the firm

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<sup>274</sup> *ibid* 80 – 81.

<sup>275</sup> *ibid* 81.

<sup>276</sup> [1966] 2 Q.B. 431.

<sup>277</sup> *Ellinger and others* (n 272) 82 – 83.

<sup>278</sup> *United Dominions Trust Ltd* (n 276) 447.

<sup>279</sup> *Ellinger and others* (n 272) 84.

*amongst ordinary intelligent commercial men. If they recognise it as carrying on the business of banking, that should turn the scale*"<sup>280</sup>.

Apart from the common law definition of "*banks*" which has been adopted by Courts in the UK, the CRR has introduced a common definition of "*credit institutions*" throughout the EU, with this therefore also applying within the UK. This definition is considered in further detail in Section 3.1.2 below, and as will be seen there is still insufficient detail in order for there to be proper harmonization of what this definition actually means. Though different definitions of "*banks*" or of "*credit institutions*" apply in the UK (according to the specific statute one would be referring to), when considering the prudential requirements set out by the Basel Accords, one should consider the definitions adopted by the CRR discussed below given that this is the regulation (together with the Capital Requirements Directive IV ("**CRD IV**")) which implements the Basel Accords within the EU<sup>281</sup>.

### **3.1.2 European Union**

Apart from adopting the Basel Accords in the EU, the CRD IV and the CRR establish the prudential regulatory requirements for credit institutions and investment firms throughout the EU.

The CRR establishes definitions for both "*credit institutions*" and "*investment firms*" (with these definitions being applicable to both the CRD IV and the CRR). Article 4 of the CRR defines a "*credit institution*" as "*an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*". There

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<sup>280</sup> *United Dominions Trust Ltd* (n 276) 454.

<sup>281</sup> Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance [2013] OJ L 176/ 338 (CRD IV). At the time of writing discussions are ongoing for the CRD IV to be amended by what is being referred to as "*CRD V*"; See: European Commission, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards Exempted Entities, Financial Holding Companies, Mixed Financial Holding Companies, Remuneration, Supervisory Measures and Powers and Capital Conservation Measures* (COM (2016) 854 final, 2016/0364 (COD), Brussels, 23 November 2016) <<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0854&from=EN>> accessed 22 February 2017; and Council of the European Union, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards Exempted Entities, Financial Holding Companies, Mixed Financial Holding Companies, Remuneration, Supervisory Measures and Powers and Capital Conservation Measures – Presidency Compromise* (Interinstitutional File 2016/0364 (COD), 6615/18, Brussels, 6 March 2018) <<http://data.consilium.europa.eu/doc/document/ST-6615-2018-INIT/en/pdf>> accessed 4 May 2018 (CRD V).

exist no definitions, however, as to what constitutes a “*deposit*”, “*other repayable fund*”, “*grants credits*” or “*from the public*”, throughout the CRR<sup>282</sup>. Different EU member states have therefore adopted varying approaches to how these terms are to be interpreted.

The European Banking Authority (“EBA”) has recognised that there are differences between the definition of “*credit institutions*” which has been adopted at EU level and the different definitions which have been adopted at national level by different member states<sup>283</sup>. Though the EBA has stated that “[i]n light of the weight placed on this term the EBA notes that it is of considerable importance that it is interpreted in a uniform manner across the Union”, it has, at this stage, only acknowledged this problem and has not put forward a solution on how these divergences are to be rectified<sup>284</sup>. It has however urged the Commission to give consideration to a possible clarification to the definition of “*credit institution*” in light of the incongruences between the laws of the different EU member states<sup>285</sup>.

Differences therefore clearly exist between EU law definitions and definitions adopted in national legislative texts. As seen above, one can neither assume that the term “*credit institution*” or “*bank*” has the same meaning within a particular jurisdiction, given that, for example, the test in the UK common law for an entity to be considered as a “*bank*” is more onerous than that required at EU level, such that the taking of deposits and granting of loans, which is the requisite emanating from EU regulations, has been considered as an insufficient test by English Courts when considering the definition of “*banks*” in relation to specific statutes.

Furthermore, one should also be aware that not all financial activities carried out by banks necessitate being licensed as a “*credit institution*”, given that one only requires this licence if the said entity accepts “*deposits or other repayable funds from the public*”, and “*grants credits for its own account*”. By way of example, payment institutions regulated

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<sup>282</sup> European Banking Authority, *Report to the European Commission on the perimeter of credit institutions established in the Member States* (27 November 2014) 4 para. 11 <<https://www.eba.europa.eu/documents/10180/534414/2014+11+27+-+EBA+Report+-+Credit+institutions.pdf>> accessed 4 December 2014.

<sup>283</sup> European Banking Authority, *Opinion of the European Banking Authority on Matters Relating to the Perimeter of Credit Institutions* (EBA/Op/2014/12, 27 November 2014) <<https://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-12+%28Opinion+on+perimeter+of+credit+institution%29.pdf>> accessed 4 December 2014 (EBA Opinion Relating to the Perimeter of Credit Institutions); See also: European Banking Authority (n 282).

<sup>284</sup> EBA Opinion Relating to the Perimeter of Credit Institutions (n 283) 3.

<sup>285</sup> *ibid.*



by the second Payment Services Directive<sup>286</sup> are not considered to be “*credit institutions*” notwithstanding that the activities they carry out are similar to certain activities carried out by banks and are also listed in the “*business lines*” of credit institutions in the Basel Accords (on dealing with capital charges in the Standardised approach, as seen above), with payment institutions still being subject to certain risks faced by banks (such as “*herstatt*” risk<sup>287</sup>). Furthermore activities of other financial institutions, such as factoring, leasing and hire purchases are generally only regulated at a national level, and the type of licence needed to carry out these activities varies between one member state and another.

### 3.1.3 United States

Defining a “*bank*” in the US has also proved problematic, particularly in light of the wide functions carried out by banks. In 1988, Pollard<sup>288</sup> stated that:

*[f]or years, laymen and legal practitioners understood what a bank was; today, even the definition of bank is subject to intense debate, particularly when distinguishing a bank from the many other depository and nondepository providers of financial services.*

Pollard continued by stating<sup>289</sup>:

*... depository institutions are but one sector of financial service providers. Insurance companies, mortgage companies, finance companies, diversified holding companies, mutual funds, securities firms, foreign banks and other foreign institutions operating in the United States, automobile companies, and retailers all provide various forms of consumer and commercial financial products.*

Though historically the definition of “*bank*” in the US implied there being “*a place for the deposit of money, as that is the most obvious purpose of such an institution*<sup>290</sup>,” the term “*bank*” itself has become blurred and is mostly used as a generic term. One should also

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<sup>286</sup> Directive 2015/2366/EU of the European Parliament and of the Council on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC [2015] OJ L 337 (Payment Services Directive).

<sup>287</sup> This refers to cross-country settlement risk and which takes its name after the failure of the Herstatt Bank in Germany in 1974.

<sup>288</sup> Alfred M. Pollard and others, *Banking law in the United States* (Butterworth Legal Publishers, 1988) 29.

<sup>289</sup> *ibid.*

<sup>290</sup> See: *Oulton v. German Savings and Loan Society* 84 US (17 Wall) 109 (1873).

note, however, that similar to the UK, various statutes in the US have also sought to define a “bank” for the particular statutory purposes of those same specific statutes<sup>291</sup>.

Therefore, in US regulation, the main classification of financial institutions refers to “depository institutions” and “nondepository institutions” (with the latter also referred to as “nonbanks”)<sup>292</sup>. The four major types of financial depository institutions in the US are: commercial banks, savings and loan associations, savings banks and credit unions<sup>293</sup>. The function of commercial banks is typically that of providing retail banking, whereby short-term business credit is provided, together with deposit (including time and savings) accounts, carrying out of fiduciary activities, as well as providing consumer loans and mortgage loans<sup>294</sup>. Savings and loan associations specialise in residential real estate lending and home finance, whilst savings banks specialise in consumer loans, including home finance<sup>295</sup>. Credit unions provide personal and consumer loans to individuals who have a “common bond”, such as through employment, or some social or labour organisation<sup>296</sup>.

On the other hand, nondepository institutions do not accept deposits from the public and include securities firms, mutual funds, insurance companies, consumer finance, leasing and mortgage companies, and lending and finance subsidiaries of major industrial companies<sup>297</sup>.

Nondepository institutions and depository institutions may also be affiliated with each other through a financial holding company<sup>298</sup> (though these are subject to restrictions introduced by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>299</sup> as will be discussed in further detail in Section 3.3)<sup>300</sup>. However, given that these institutions do not accept deposits, they are subject to less regulation, and are generally regulated at state level rather than at a federal level in the US. These

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<sup>291</sup> William H. Schlichting and others, *Banking Law* (Matthew Bender, 1986 - ) para. 1.03[2].

<sup>292</sup> *ibid* para. 1.01, 1.05; See also: PricewaterhouseCoopers, *A Regulatory Guide for Foreign Banks in the United States* (2007 – 2008 edition, PricewaterhouseCoopers LLP, 2007) 1 – 2 <[https://www.pwc.com/us/en/banking-capital-markets/publications/assets/pwc\\_0708\\_foreign\\_banks\\_guide.pdf](https://www.pwc.com/us/en/banking-capital-markets/publications/assets/pwc_0708_foreign_banks_guide.pdf)> accessed 12 December 2014.

<sup>293</sup> Schlichting (n 291) para. 1.01, 1.05.

<sup>294</sup> *ibid* para. 1.05; PricewaterhouseCoopers (n 292) 1.

<sup>295</sup> *ibid*.

<sup>296</sup> *ibid*.

<sup>297</sup> Schlichting (n 291) para. 1.05; See also: PricewaterhouseCoopers (n 292) 2.

<sup>298</sup> *ibid*.

<sup>299</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o) [Bluebook R. 12.4] (Dodd-Frank Act).

<sup>300</sup> Schlichting (n 291) para. 1.05; See also: PricewaterhouseCoopers (n 292) 2.

institutions are generally not subject to the same type of capital requirements applicable to depository institutions, and the main focus of regulation on these entities is mainly in the form of state licensing and oversight, with the main focus being on consumer protection<sup>301</sup>.

### **3.2 Banks, Investment Firms and Shadow Banks**

Though the promoters of the Basel Accords sought to apply the Basel Accords to “*internationally-active banks*”, no definition has been given as to what the terms “*internationally-active*” and “*bank*” mean. As seen above there neither is a clear definition across borders as to what the term “*bank*” means, and as will be seen in Section 3.4, there have also been inconsistencies in that jurisdictions such as the EU extended the Basel Accords not only to all banks, but also to “*investment firms*”. On the other hand, the Basel Accords have not been extended to entities which provide similar activities to those of a bank (referred to as “*shadow banks*”).

Given the different types of entities which will be considered below (namely banks, investment firms, and shadow banks), a brief commentary as to what the main differences between these entities are, is warranted. Reference is generally made to EU law given that throughout this thesis the EU is considered as the main example as to where the provisions of the Basel Accords have been extended to investment firms.

#### **3.2.1 Distinguishing between banks, investment firms, and shadow banks**

In the EU, the general rule established by CRD IV and the CRR<sup>302</sup> is that firms classified as “*investment firms*” under the Markets in Financial Instruments Directive (“**MiFID**”)<sup>303</sup>, will also be considered as “*investment firms*” for the purposes of the CRD IV and the CRR

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<sup>301</sup> *ibid.*

<sup>302</sup> Article 4 of the CRR defines “*investment firm*” as: *a person as defined in point (1) of Article 4(1) of Directive 2004/39/EC, which is subject to the requirements imposed by that Directive, excluding the following: (a) credit institutions; (b) local firms; (c) firms which are not authorised to provide the ancillary service referred to in point (1) of Section B of Annex 1 to Directive 2004/39/EC, which provide only one or more of the investment services and activities listed in points 1, 2, 4 and 5 of Section A of Annex 1 to that Directive, and which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients.*

<sup>303</sup> Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L 145 (MiFID). This has since been recast as Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L 173 (MiFID II).

subject to a few exceptions<sup>304</sup>, and that wherever clients' assets are held by a firm, or where a firm deals on own account, then that firm would be classified as an "*investment firm*" for the purposes of the CRD IV and the CRR, and would hence be subject to the provisions thereof. The term "*investment firm*" is generally defined by MiFID as "*any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis*"<sup>305</sup>.

Within the EU context, one should also distinguish between "*investment firms*" and "*alternative investment fund managers*" ("**AIFMs**" and also referred to as "*hedge fund managers*"), given that the latter may or may not be classified as "*investment firms*" for the purposes of MiFID, depending on the type of activities they carry out. Firms cannot be classified as both "*investment firms*" under MiFID, and as "*Alternative Investment Fund Managers*" in terms of the Alternative Investment Fund Managers Directive ("**AIFMD**") at the same time<sup>306</sup>. However, an AIFM may be authorised to perform certain MiFID services, in terms of the AIFMD (and not in terms of MiFID) and in such case, an AIFM which performs both AIFM activities and permitted additional MiFID activities will be required to comply with certain capital requirements established by the CRD IV<sup>307</sup>.

Alternative investment funds ("**AIFs**" also referred to as "*hedge funds*") are asset pools managed by an AIFM, which provide similar functions to banks (and can be referred to within the wider term of "*shadow banking*") but these are not subject to the same regulatory restrictions as banks. They are primarily distinguished from other investment vehicles and mutual funds in that hedge funds are those investment funds

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<sup>304</sup> A firm will **not** be considered as an "*investment firm*" for the purposes of the CRD IV and the CRR if: (a) it **only** provides the following investment services and activities: (i) reception and transmission of orders in relation to one or more financial instrument; (ii) execution of orders on behalf of clients; (iii) portfolio management; and/ or (iv) investment advice; (b) it does not provide safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management; and (c) it does not hold clients' money.

<sup>305</sup> Article 4, MiFID II (n 303).

<sup>306</sup> Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L 174/1 (AIFMD).

<sup>307</sup> *Practical Law Financial Services, AIFMD: Capital Requirements for Managers* <<http://uk.practicallaw.com/1-503-9737?q=capital+requirements+regulation#a575183>> accessed 15 December 2014.

which fall out of the regulatory scope of mutual fund regulation<sup>308</sup>. Therefore, from a legal perspective, hedge funds (and other shadow banks generally) are not regulated, though following the global financial crisis AIFMs have been subject to very limited regulation through the provisions of the AIFMD in the EU (and with similar restrictions also being applied by the Dodd-Frank Act in the US).

Defining what a “*hedge fund*” is has proved problematic such that IOSCO proved unable to establish a definitional term of a “*hedge fund*” and noted that “*each jurisdiction has views on what a hedge fund is*”<sup>309</sup>. Furthermore, the FSB has defined “*shadow banking*” as “*credit intermediation involving entities and activities outside the regular banking system*”<sup>310</sup>. Similarly the EBA has defined “*shadow banking entities*” as entities that<sup>311</sup>:

- a. carry out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and*
- b. are neither within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks). Entities referred to in Article 2(5) and Article 9(2) of Directive 2013/36/EU, as well as other entities as defined in the guidelines ('excluded undertakings'), are also not to be regarded as shadow banking entities.*

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<sup>308</sup> Andreas Engert, *Transnational Hedge Fund Regulation* (European Business Organization Law Review, Vol. 11, Cambridge Journals, 2010) 333 <<http://journals.cambridge.org/abstract/S1566752910300036>> accessed 9 January 2015.

<sup>309</sup> David Howarth and Lucia Quaglia, ‘Hedge Funds’ in Daniel Mügge (ed), *Europe and the Governance of Global Finance* (OUP, 2014) 114.

<sup>310</sup> Financial Stability Board, *Shadow Banking: Scoping the Issues* (Financial Stability Board, 12 April 2011) 1 <[http://www.financialstabilityboard.org/wp-content/uploads/r\\_110412a.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_110412a.pdf)> accessed 30 April 2015 (FSB April 2011); Jan Putnis and Tolek Petch, ‘International Initiatives’ in Jan Putnis (ed), *The Banking Regulation Review* (Law Business Research Ltd, May 2015) 22; Financial Stability Board, *Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board* (Financial Stability Board, 27 October 2011) 1, 3 (FSB October 2011); Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: An Overview of Policy Recommendations* (Financial Stability Board, 29 August 2013) iv (FSB August 2013); Financial Stability Board, *Global Shadow Banking Monitoring Report 2014* (Financial Stability Board, 30 October 2014) 1 (FSB October 2014); A similar definition has also been adopted by Aquilina and Kraus who have described “*shadow banking*” as “*credit intermediation carried out by non-banks*”; See also: Matteo Aquilina and Wladimir Kraus, *Market-Based Finance: Its Contributions and Emerging Issues* (Financial Conduct Authority, Occasional Paper 18, May 2016) 8 <<https://www.fca.org.uk/publication/occasional-papers/occasional-paper-18.pdf>> accessed 13 April 2017.

<sup>311</sup> European Banking Authority (n 328) 7.

The EBA has provided the following examples of what may constitute a shadow banking entity: money market funds; special purpose vehicles engaged in securitisation transactions; securities and derivatives dealers, as well as companies engaged in factoring, leasing or hire purchase<sup>312</sup>. It has also clarified that all funds would be considered to be “*shadow banking entities*” except if they are non-Money Market Funds Undertakings for Collective Investment in Transferable Securities (“UCITS”), AIFs with limited leverage, or any third country funds which are subject to UCITS equivalent requirements<sup>313</sup>.

Therefore shadow banks and hedge funds (or AIFs) are generally defined by simply referring to all funds which are not regulated<sup>314</sup>. This all-embracing terminology has been considered to be fundamental in order to encapsulate all forms of shadow banks given that they are typically too diverse in nature with their main common factor generally being linked to the type of returns which they seek to deliver<sup>315</sup>.

### 3.2.2 Extending Capital Adequacy Laws to Investment Firms

The rationale for capital adequacy restrictions being necessarily mandated for banks but not for other firms (by the BCBS, and consequently in certain jurisdictions implementing the Basel Accords) has traditionally been that banks have been considered to pose much greater systemic risks than investment firms<sup>316</sup>. This argument has been put forward since banks hold deposits (from the public at large), which makes them vulnerable to loss of confidence by the public at large<sup>317</sup>.

Investment firms do not hold deposits from the public (though they do hold client funds) and it has therefore been argued that they do not create risks to public funds<sup>318</sup>. Furthermore, investment firms are generally funded by banks or through capital

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<sup>312</sup> *ibid* 8.

<sup>313</sup> *ibid* 10.

<sup>314</sup> A wide definition has also been adopted by the AIFMD, which has defined “*alternative investment funds*” as follows: “‘AIFs’ means collective investment undertakings, including investment compartments thereof, which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC”; AIFMD (n 306) Article 4(1)(a).

<sup>315</sup> Engert (n 308) 333.

<sup>316</sup> Wood (n 1) 27.

<sup>317</sup> *ibid*.

<sup>318</sup> Banks are considered to create risks to public funds as a result of States holding the ultimate responsibility for depositor insurance schemes. Though funds held by investment firms also benefit from investor compensation schemes, these are much more limited in scope.

markets, rather than through deposits obtained directly from the public<sup>319</sup>. Therefore, once investment firms enter the realm of insolvency, they should be able to realise their assets in a much quicker way than banks<sup>320</sup>. Moreover, whilst banks typically provide for long-term and medium-term financing, investment firms typically have shorter-term contracts (such as underwriting commitments)<sup>321</sup>.

Another significant difference between banks and investment firms also arises in the way in which each of these entities holds clients' funds. Whilst banks pool deposits they receive in order to grant credit to their customers (as part of the credit intermediation function they carry out), investment firms are typically required to separate client assets from their own assets, resulting in there being further protection of clients' funds in investment firms<sup>322</sup>.

Thus, prior to the global financial crisis it was argued that prudential regulation of investment firms should be restricted to ensuring an orderly wind-down or transfer of an investment firm's business and the protection of client's assets in the event of an insolvency of an investment firm<sup>323</sup>. Wood therefore stated that the focus in regulating investment firms should be on "*non-capital financial requirements*", such as requiring professional indemnity insurance and the segregation and holding of client monies and securities on trust, rather than on capital requirements<sup>324</sup>.

Though the traditional view has been that banks are systemically more important than investment firms, particularly due to banks providing liquidity to the economy, and due to being inter-connected with other banks<sup>325</sup>, in recent years and particularly following the recent global financial crisis, investment firms have also been recognised as having become essential providers of liquidity, whilst having also continued to be even further intermingled with banks. Furthermore, there has since also been the rise of other "*non-banks*", particularly shadow banks which have further complemented banks in the services they provide.

Nevertheless, different jurisdictions have adopted diverging positions (as will be seen in Section 3.4) leaving investment firms in different jurisdictions subject to different types

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<sup>319</sup> Wood (n 1) 27.

<sup>320</sup> *ibid.*

<sup>321</sup> *ibid.*

<sup>322</sup> *ibid* 27, 621 - 622. See also: MiFID II (n 303) Article 16.

<sup>323</sup> Wood (n 1) 622.

<sup>324</sup> *ibid.*

<sup>325</sup> *ibid.*

of laws, thereby giving rise to regulatory arbitrage opportunities between different states and allowing for the possibility of transfer of risk from the regulated to the unregulated sectors. The US have adopted the reasoning that in light of the intrinsic differences between banks and investment firms, capital adequacy restrictions should be applied only to “banks” (and non-banks which would have become systemically important). On the other hand, in the EU greater emphasis has been placed on the need to have a level playing field and competitive equity between different providers of finance, thus extending the provisions of the laws implementing the Basel Accords to “investment firms”.

### 3.2.3 Extending Capital Adequacy Laws to Shadow Banks

Whereas towards the end of the twentieth century one could still identify various distinctions between “banks” and “non-banks”, and though the risks between the two were still considered as being completely separate and distinct, the global financial crisis has led to the growth of non-banks and the shadow banking industry, resulting in further intermingling between the two. Consequently, most of the arguments which used to be brought in favour of distinguishing between banks and non-banks when applying financial regulation have either been disproved by the global financial crisis, or alternatively can no longer be said to apply in light of the growth of these non-banks<sup>326</sup>.

Though many entities engage with hedge funds in financial activities that are similar to banking activities, Basel III is generally not extended to shadow banks and hedge funds (both in the EU and other jurisdictions such as the US) notwithstanding the arguments for the need for there to be competitive equity which the EU had put forward on extending capital adequacy regulation to investment firms<sup>327</sup>.

Whilst it has been argued that shadow banks (and more specifically hedge funds) should be treated as banks and regulated as such, with capital adequacy requirements being extended to hedge funds too, others remain in favour of distinguishing between the two<sup>328</sup>. The proponents of distinguishing regulation between banks and shadow banks

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<sup>326</sup> For an example as to reasons which were given in 1999 as to why distinctions should be drawn between “banks” and “non-banks” see: David Llewellyn, *The Economic Rationale for Financial Regulation* (Financial Services Authority, Occasional Paper Series 1, April 1999) 20.

<sup>327</sup> Wulf A Kaal, *Hedge Fund Regulation via Basel III* (Vanderbilt Journal of Transnational Law, Vol. 44, Vanderbilt University Law School, 2011) 440 <<http://ssrn.com/abstract=1806252>> accessed 17 December 2014.

<sup>328</sup> Engert (n 308) 344. One should here also recognize that distinguishing between banks and shadow banks has been advocated in light of shadow banking providing an alternative source of financing to markets and help in maturity transformation, and this particularly in a scenario



state that whilst banks are barely subject to private monitoring, as banks' creditors are usually weak creditors (when compared to the bank) who typically do not require security interests from the bank, hedge funds generally deal with prime brokers which ensure effective monitoring and supervision of hedge funds (as their creditors), thereby acting as an effective method of supervision<sup>329</sup>.

Heremans and Paces have observed that *"the adoption of very complex and sophisticated financial innovations in the quest for profit has determined structural shifts in the financial intermediation process"* and that as a result *"the core of traditional banking intermediation has declined significantly"*<sup>330</sup>. Other financial intermediaries, such as institutional investors, hedge funds, private equity funds, and new specialized investment vehicles have become new sources of financial intermediation, and that as a result, *"financial risks are transferred from the highly regulated banking sector to non-regulated intermediaries, thereby becoming more difficult to monitor"*<sup>331</sup>. Banks continue to be exposed to risks arising from the financial system as when the stability of non-banking institutions is *"shaken"*, investors tend to resort to banks in light of them being *"regulated"* and considered to be of a higher quality than non-banking entities, thereby putting a strain on banks which may lead to systemic risks and effects<sup>332</sup>. Furthermore, non-banks are considered to be more risky than banks as they cannot rely on Central Banks as a lender of last resort and are therefore more akin to failure in the event of

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where banks have been providing limited liquidity to markets. Shadow banks have therefore been considered by some as contributing to financial stability in markets in light of them being able to fill the financing gap which bank financing is not willing to provide for. The proponents of these arguments do not however enquire whether this has come about in light of the stringent regulations banks face (i.e. as against shadow banks) and whether shadow banks can provide this function in light of them not being subject to the stringent regulations which banks are subject to. See: International Monetary Fund, *The Future of Finance – Session 3: Expanding Role of Nonbanks* (Seminar moderated by Vitor Constâncio and addressed by Chitra Ramkrishna, Nouriel Roubini, Lord Adair Turner, and Nor Shamsiah Mohd Yunus, International Monetary Fund, World Bank Group, 2014 Annual Meetings, Washington D.C., October 10-12) <<http://www.imf.org/external/POS/Meetings/SeminarDetails.aspx?SeminarId=15>> accessed 7 August 2015; European Banking Authority, *Guidelines: Limits on Exposures to Shadow Banking Entities Which Carry Out Banking Activities Outside a Regulated Framework Under Article 395(2) of Regulation (EU) No 575/2013* (EBA/GL/2015/20, 14 December 2015) 5, 12 <<http://www.eba.europa.eu/documents/10180/1310259/EBA-GL-2015-20+GL+on+Limits+to+Exposures+to+Shadow+Banking+Entities.pdf>> accessed 24 December 2015.

<sup>329</sup> Engert (n 308) 344.

<sup>330</sup> Dirk Heremans and Alessio M Paces, *Regulation of Banking and Financial Markets* (Rotterdam Institute of Law and Economics Working Paper Series No. 2011/04) 4 <<http://ssrn.com/abstract=1914461>> accessed 24 January 2016.

<sup>331</sup> Meyer (n 97) 4.

<sup>332</sup> Heremans and Paces (n 330) 4.

illiquidity as their only remedy is to resort to debt in order to increase their liquidity and satisfy panicking investors<sup>333</sup>.

It has also been argued that many of the regulatory complications in the AIFMD and Dodd-Frank Act could be avoided through the introduction of a charge for banks' lending exposures to hedge funds, since this would minimise systemic risk in the lending practice of banks to hedge funds<sup>334</sup>. This proposal has been adopted by the BCBS and will be discussed in further detail in Section 5.4 below.

### ***3.3 The Evolution of the Structure of Banks: Separation of Retail and Commercial Banking from Investment Banking Activities***

Notwithstanding the aforementioned definitions of “banks” one should also be aware of the evolving structure of banks, particularly in light of the applicable laws and regulations to banks and to alternative methods of financing. As will be explained below, the capital requirements arising out of the Basel Accords, have, along the years, been extended also to investment firms in a number of jurisdictions (including in the EU through the applicability of the CRR). This is however not a common approach, and there still are other important jurisdictions (such as the US) where the extension of the Basel Accords to investment firms is much more limited.

This comes against a backdrop of a marked shift from bank financing to alternative methods of financing, such as through shadow banks, investment firms and specialised investment banks, which have continued to expand in light of regulatory restrictions which limit proprietary trading activities by banks. As regulatory reforms have sought to separate retail and commercial banking from investment banking activities, there has been a further increase in financing activities being carried out by investment firms and non-banks, with the latter entities generally being able to benefit from less regulation than banks (particularly by being able to make use of differences in the laws and regulations of different jurisdictions)<sup>335</sup>.

This demonstrates that though depositors' funds held with banks may be better protected in light of the reforms which split retail banking from proprietary trading, the

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<sup>333</sup> *ibid* 6.

<sup>334</sup> Engert (n 308) 397 – 398.

<sup>335</sup> Charles K. Whitehead, *The Volcker Rule and Evolving Financial Markets* (Harvard Business Law Review, Vol. 1, Cornell Legal Studies Research Paper No. 11-19, 1 June 2011) 39, 44 – 45 <<http://ssrn.com/abstract=1856633>> accessed 2 December 2014; Céline Choulet, *Dodd-Frank Act: the US vision on financial regulation* (BNP Paribas, May-June 2011) 6, 9 – 10 <[http://cib.bnpparibas.com/01/MyDocuments/C1105-06\\_A2.pdf](http://cib.bnpparibas.com/01/MyDocuments/C1105-06_A2.pdf)> accessed 10 December 2014.

risks which arise from proprietary trading are now being passed on to less regulated entities. Even so, banks (and hence depositors' funds), may still not be completely free from these risks given that banks also rely on shadow banks to manage credit risk (such as through credit default swaps), and will therefore remain exposed to proprietary trading risks nonetheless<sup>336</sup>.

The relevance of this discussion is that as the investment banking arm of banks is being segregated into new or separate entities, these entities may now be more properly classified as "*investment firms*" or "*nonbanks*" given that they may no longer take or rely on deposits or other repayable funds from the public. Thus, this may mean that investment banking activities may start falling out of the regulatory scope of those jurisdictions where the Basel Accords' implementing laws are not extended to "*investment firms*".

A brief description of the reforms which are taking place in this context will follow.

### 3.3.1 European Union

A number of jurisdictions, including the UK and Germany, have sought to separate retail banking activities from investment banking activities, notwithstanding the vast differences in the banking culture of these states and the existence of universal banks, or otherwise, in these jurisdictions along the years<sup>337</sup>.

Following the recent global financial crisis, a reform of the universal banking model in the UK was proposed by various commentators and bodies in the industry, such as the Governor of the Bank of England<sup>338</sup>, the Future of Banking Commission<sup>339</sup>, and others<sup>340</sup>,

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<sup>336</sup> Whitehead (n 335) 39, 44 – 45; Choulet (n 335) 12.

<sup>337</sup> For an analysis as to how the banking system has developed see: Richard Davies and others, *Evolution of the UK Banking System* (Bank of England, Quarterly Bulletin, 2010 Q4) 321; Independent Commission on Banking, *Interim Report: Consultation on Reform Options* (April 2011) 109 – 110 <[http://webarchive.nationalarchives.gov.uk/20121204124254/http://www.hm-treasury.gov.uk/d/icb\\_interim\\_report\\_full\\_document.pdf](http://webarchive.nationalarchives.gov.uk/20121204124254/http://www.hm-treasury.gov.uk/d/icb_interim_report_full_document.pdf)> accessed 3 December 2014 (ICB Interim Report); John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor* (Columbia Law Review, Vol. 91, No. 6, Columbia Law Review Association, October 1991) 1303 – 1304; Jordi Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* (Clarendon Press, 1997) 161.

<sup>338</sup> Avgouleas (n 17) 8.

<sup>339</sup> David Davis and others, *The Future of Banking Commission* (Which?, March 2010) 27 – 32 <<http://www.staticwhich.co.uk/documents/pdf/future-of-banking-commission-report-355539.pdf>> accessed 3 December 2014.

<sup>340</sup> For a further analysis see: George C. Bugeja, *Universal Banking and the Return of 'Glass-Steagall'* (Elsa Malta Law Review, Edition II, Elsa Malta, 2012) 108 – 110.

resulting in the appointment of the Independent Commission on Banking, which published its final report and its recommendations in September 2011<sup>341</sup>. These recommendations included the imposition of a ring-fencing requirement for the retail activity of banks, with a view to isolating those banking activities where continuous provision of service is vital to the economy and to banks' customers<sup>342</sup>. Thus the Independent Commission on Banking proposed that retail banking activities should be carried out in a separate subsidiary, in order to ensure legal, economic and operational separation from the rest of the banking group<sup>343</sup>. The recommendations of the Independent Commission on Banking were formally adopted and enacted by the Financial Services (Banking Reform Act) of 2013<sup>344</sup>. Therefore, as from 1<sup>st</sup> January 2019, UK banking groups with significant retail and small and medium-sized enterprise banking operations will be required to "ring-fence" certain deposit-taking activities for retail and small and medium-sized enterprise depositors in a legal entity that will not be permitted to carry on certain specified wholesale and investment banking activities<sup>345</sup>.

Similarly, other major financial jurisdictions in the EU have adopted a similar approach by requiring retail banking activities to be carried out by separate subsidiaries from other subsidiaries carrying out proprietary trading activities. In Germany this ring-fencing requirement has been introduced by the *Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups*, enacted on 7 June 2013<sup>346</sup>. Similarly, in France this has been required by *Loi no. 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires*<sup>347</sup>.

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<sup>341</sup> Independent Commission on Banking, *Final Report – Recommendations* (September 2011) <<http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf>> accessed 3 December 2014 (ICB Final Report).

<sup>342</sup> Bugeja (n 340) 10 – 11.

<sup>343</sup> *ibid.*

<sup>344</sup> Financial Services (Banking Reform) Act 2013, c. 33; Jan Putnis and Nick Bonsall 'United Kingdom' in Jan Putnis (ed), *The Banking Regulation Review* (Law Business Research Ltd, May 2015) 644.

<sup>345</sup> Jan Putnis and Nick Bonsall (n 344) 644 – 645, 654 – 655.

<sup>346</sup> See: Act on Ringfencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups (7 June 2013) <[http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2013/fa\\_bj\\_2013\\_07\\_trennbankengesetz\\_en.html](http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2013/fa_bj_2013_07_trennbankengesetz_en.html)> accessed 10 December 2014; There however here exists a materiality threshold whereby only those banks whose trading portfolio and liquidity reserve exceed €100 billion, or exceed 20% of total assets and amount to at least €90 billion, will be affected.

<sup>347</sup> See: Loi no. 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires (26 July 2013)

The EU has also been establishing its own proposals for legislation in order to separate proprietary trading and other significant trading activities from retail and commercial banking<sup>348</sup>. This separation was proposed by the High-level Expert Group on reforming the structure of the EU banking sector (the “*Liikanen Report*”), and has currently resulted in a Proposal for a Regulation of the European Parliament and of the Council on Structural Measures Improving the Resilience of EU Credit Institutions<sup>349</sup>. This proposal goes one step further than the ring-fencing structures which have been proposed in national frameworks, since the current version of the proposed legislation will impose an outright ban of engaging in proprietary trading and other trading activities on own account, with this being extended to the whole group of entities to which a credit institution forms part<sup>350</sup>.

### 3.3.2 United States

In the US, the separation of retail and commercial banking from investment banking has varied greatly along the years with the Glass-Steagall Act being introduced in 1933 in order to separate commercial banking from investment banking<sup>351</sup>.

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<<http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000027754539>> accessed 10 December 2014; It is expected that materiality thresholds will also be applied here.

<sup>348</sup> See: European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Structural Measures Improving the Resilience of EU Credit Institutions* (COM(2014) 43 final, 2014/0020(COD), Brussels, 29 January 2014) (Proposal for a Regulation to Improve the Resilience of Credit Institutions).

<sup>349</sup> Erkki Liikanen and others, *High-Level Expert Group on Reforming the Structure of the EU Banking Sector* (Brussels, 2 October 2012) <[http://ec.europa.eu/internal\\_market/bank/docs/high-level\\_expert\\_group/report\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf)> accessed 15 December 2014; Proposal for a Regulation to Improve the Resilience of Credit Institutions (n 348).

<sup>350</sup> Proposal for a Regulation to Improve the Resilience of Credit Institutions (n 348) arts 3 and 6; Barnabas W B Reynolds and others, *United States: Comparison of New EU Proposals On Proprietary Trading and Ring-Fencing against US, UK, French and German Rules* (Shearman & Sterling LLP, 3 March 2014) <<http://www.mondaq.com/unitedstates/x/296882/securitization+structured+finance/Comparison+Of+New+EU+Proposals+On+Proprietary+Trading+And+RingFencing+Against+US+UK+French+And+German+Rules>> accessed 15 December 2014. This proposal also has materiality thresholds: it is currently proposed for these regulations to apply to European banks which are deemed to be of global systemic importance, or those banks which exceed certain thresholds for three consecutive years (i.e. (a) having bank total assets exceeding €30 billion; and (b) the bank's total trading assets and liabilities exceed €70 billion or 10 percent of their total assets).

<sup>351</sup> Randall S Kroszner, Raghuram G Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1993* (The American Economic Review, Vol. 84, No. 4, American Economic Association, September 1994) 812 <<http://www.jstor.org/stable/2118032>> accessed 16 December 2014; Ross Cranston, *Principles of Banking Law* (OUP, 2002) 99; Folarin Akinbami, “The Global Financial Crisis: Causes, Effects and Issues to Consider in the Reform of

Following the recent global financial crisis, proprietary trading was blamed as being one of the reasons for the crisis, resulting in the “*Volcker Rule*” being promulgated, and with this being based on concepts which are similar to those of the Glass-Steagall Act<sup>352</sup>. This was introduced by Section 619 of the Dodd-Frank Act, which prohibits proprietary trading (or acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or private equity fund, subject to certain exceptions) by banking entities<sup>353</sup>.

### **3.4 Applicability of the Basel Accords**

Whilst the Basel Accords fail to provide clarity regarding the granular activities which should be regulated, the scope of their application specifically refers to the regulation of “*internationally-active banks*”. However, as seen above, different jurisdictions have different interpretations as to what constitutes a “*bank*”. Furthermore some jurisdictions have sought to extend the applicability of the Basel Accords to institutions other than “*internationally-active banks*”. This Section therefore considers the entities to which the Basel Accords have been extended across different jurisdictions.

It can be argued that, whilst the applicability of the Basel Accords to internationally-active banks was essential in order to ensure that lighter-regulated banks did not impact banks in other jurisdictions, the importance of the Basel Accords arises since the Basel Accords have been applied to a much wider list of institutions than originally envisaged, and have become a global standard of how banks are regulated (irrespective of the size of the particular bank, the activities which it carries out, and whether it operates internationally or otherwise). Therefore a transnational regulatory law which was meant to apply to a very specific type of entity has thrived in the absence of other regulation being put in place, notwithstanding that no proper economic analysis was carried out in order to ascertain whether the Basel Accords could provide an adequate framework for the regulation of all banks (and other entities such as investment firms).

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Financial Regulation’ in Suk-Joong Kim, Michael D. McKenzie (eds) *International Banking in the New Era: Post-Crisis Challenges and Opportunities* (Emerald Insight, 2010) 174 – 175; Canals (n 337) 76; Michael S. Raab, *The Transparency Theory: An Alternative Approach to Glass-Steagall Issues* (The Yale Law Journal, Vol. 97, No. 4, The Yale Law Journal Company Inc., March 1988) 605, 607 – 609 <<http://www.jstor.org/stable/796372>> accessed 15 December 2014; See also: Avgouleas (n 17) 13 – 14; Richard Dale, *Glass-Steagall and US Banks’ Securities Activities* (Journal of International Banking Law, Butterworths, 1990) 321 – 327.

<sup>352</sup> Whitehead (n 335) 41 – 43.

<sup>353</sup> *ibid* 39, 40, 47; Choulet (n 335) 9.



It is thus also somewhat ironic that whilst the Basel Accords regulate “*internationally-active banks*”, the BCBS has had to issue further standards which specifically apply to “*globally systemic important banks*” (at times also referred to as “*G-SIBs*”)<sup>354</sup>.

### 3.4.1 European Union

Article 1 of the CRR specifically states that the scope of application of the regulations established by the CRR is to “*institutions*”. An “*institution*” has been defined in Article 4 of the CRR as being “*a credit institution or an investment firm*”<sup>355</sup>. Therefore, in the EU, the transposition of the Basel requirements to national legislation refers to all credit institutions (banks), with this being extended also to investment firms<sup>356</sup>. The position adopted by the EU has remained consistent throughout the years, with Council Directive 93/6/EEC<sup>357</sup> and the EU Directive 2006/49/EC<sup>358</sup> (which had adopted the Basel I and the Basel II Accords respectively) also having been applicable to all credit institutions and investment firms without distinction.

The EU therefore does not distinguish between banks and investment firms on considering the applicability of the Basel Accords, and it neither distinguishes as to whether these entities are internationally-active or otherwise, and it merely applies this regime to all banks and investment firms irrespective of their focus, activities, size or the potential systemic risk they may pose to the economy at large. The rationale for this has been stated as follows<sup>359</sup>:

*... while the Basel capital adequacy agreements apply to “internationally active banks”, in the EU it has always applied to all banks (more than 8.300) as well as investment firms. This wide scope is necessary in the EU where banks authorised in one Member State can provide their services across the EU’s single market and as*

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<sup>354</sup> BCBS, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (BIS, July 2013) <<https://www.bis.org/publ/bcbs255.pdf>> accessed 14 December 2014; Further updates to the standards which apply to G-SIBs are also found in standards set by the BCBS in December 2017. See: BCBS, *Basel III: Finalising Post-Crisis Reforms* (BIS, December 2017) <<https://www.bis.org/bcbs/publ/d424.pdf>> accessed 17 January 2018 (Basel IV).

<sup>355</sup> See also: Richard Herring, *Implementing Basel II: Is the Game Worth the Candle?* (Financial Markets, Institutions & Instruments, Vol. 14, No. 5, Blackwell Publishing Inc, 2005) 276.

<sup>356</sup> Rainer Masera, *CRR/CRD IV: the Trees and the Forest* (April 2014) 10 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2418215&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2418215&download=yes)> accessed 14 December 2014.

<sup>357</sup> Council Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions [1993] OJ L 141.

<sup>358</sup> Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L 177.

<sup>359</sup> *ibid.*

*such are more than likely to engage in cross-border services. Also, applying the internationally agreed rules only to a subset of European banks would create competitive distortions and potential for regulatory arbitrage.*

Whilst the need to cater for “*competitive distortions and potential for regulatory arbitrage*” was the reason for extending the Basel Accords’ implementing laws to all credit institutions and investment firms, this same approach has not been adopted on the rise of shadow banking over the last decade.

It is also ironic that though the EU has always applied the Basel Accords to all banks and investment firms, the European Parliament has in November 2016, and on resolving on the finalization of Basel III, recalled “*the importance of the principle of proportionality, to be assessed not only in relation to the size of the institutions which are regulated, but also understood as a fair balance between the costs and benefits of regulation for each group of stakeholders*”<sup>360</sup>. This is ambiguous in light of the fact that though the Basel Accords only apply to “*internationally-active banks*” and not to all banks, it has been the EU itself which has imposed the requirements of the Basel Accords on all banks and investment firms without distinction.

In its resolution the European Parliament however also called on the Commission to prioritise work on

*a ‘small banking box’ for the least risky banking models, and to extend this work to an assessment of the feasibility of a future regulatory framework consisting of less complex and more appropriate and proportional prudential rules specifically adapted to different types of banking model*<sup>361</sup>.

It will be interesting to see how this resolution will develop in the near future given that in the EU the argument of “*competitive equity*” has always been used in order to favour applying the Basel Accords to all banks and investment firms irrespective of their size or nature<sup>362</sup>.

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<sup>360</sup> European Parliament (n 7) Resolution 9.

<sup>361</sup> *ibid* Resolution 19. It however seems that the need to cater for smaller entities will only be used in order to allow for a reduction in certain capital requirements when the counterparties of a bank consist of small and medium sized enterprises pursuant to Article 501 of the CRR, with CRR II proposing to extend the applicability of Article 501 further.

<sup>362</sup> Proposals which have been put forward in December 2017 suggest that a new framework should be created in order to distinguish larger investment firms from smaller investment firms, whereby larger investment firms would continue to be subject to the CRR and CRD IV, whilst smaller investment firms would no longer be subject to the same regime, but would become



### 3.4.2 United States

In the US, the laws implementing the Basel regime have been much more restricted than in the EU, with the applicability of the implementing laws being limited to “*internationally-active banks*”, with this only being extended, to some extent, on providing for the introduction of Basel III<sup>363</sup>.

Prior to the adoption of Basel III, US regulators limited the application of the Basel II standards, only to “*core banks*”<sup>364</sup> (with the US implementing law only adopting the Advanced Internal Ratings-Based (“*IRB*”) approach for these banks, without making reference to the Standardised approach or the Foundation IRB approach)<sup>365</sup>. All other banks in the US remained subject to the general US risk-based capital rules, based on Basel I, unless they elected to seek to obtain authorisation to adopt the Advanced IRB approaches, based on the Basel II standards<sup>366</sup>. The US argued that this did not prejudice

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subject to a new bespoke regime. See: European Commission, *Proposal for a Regulation of the European Parliament and of the Council on the Prudential Requirements of Investment Firms and Amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010* (COM (2017) 790 final, 2017/0359 (COD), Brussels, 20 December 2017); European Commission, *Proposal for a Directive of the European Parliament and of the Council on the Prudential Supervision of Investment Firms and Amending Directives 2013/36/EU and 2014/65/EU* (COM (2017) 791 final, 2017/0358 (COD), Brussels, 20 December 2017).

<sup>363</sup> See also: Roger W. Ferguson, Jr., *Concerns and Considerations for the Practical Implementation of the New Basel Accord* (Remarks at the ICBI Risk Management 2003 Conference, Geneva, Switzerland, 2 December 2003) <<http://www.federalreserve.gov/boarddocs/speeches/2003/20031202/default.htm>> accessed 21 November 2014.

<sup>364</sup> The definition of “*core banks*” referred to: (a) any depository institution meeting either of the following two criteria: (i) consolidated total assets of USD 250 billion or more, or (ii) consolidated total on-balance sheet foreign exposure of USD 10 billion or more; or (b) any US-chartered bank holding company (BHC) meeting any of the following three criteria: (i) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of USD 250 billion or more, (ii) consolidated total on-balance sheet foreign exposure of USD 10 billion or more, (iii) having a subsidiary depository institution that was a core bank or opt-in bank. Furthermore, a depository institution established as a subsidiary of a core-bank or of a bank which elected to adopt the Advanced Internal-Ratings Based Approach would also be considered as a “*core-bank*”. See: Basel Committee on Banking Supervision, *Basel III Regulatory Consistency Assessment (Level 2) – Preliminary Report: United States of America* (October 2012) 8, 18 <[http://www.bis.org/bcbs/implementation/l2\\_us.pdf](http://www.bis.org/bcbs/implementation/l2_us.pdf)> accessed 12 December 2014 (US Regulatory Consistency Assessment); Richard J Herring, *The Rocky Road to Implementation of Basel II in the United States* (2007) 9 <<http://fic.wharton.upenn.edu/fic/papers/07/0731.pdf>> accessed 17 December 2014; Ferguson (n 363); Herring (n 355) 276.

<sup>365</sup> US Regulatory Consistency Assessment (n 364); Herring (n 364) 9.

<sup>366</sup> US Regulatory Consistency Assessment (n 364) 8, 18; Herring (n 364) 9.

international convergence of the Basel Accords, and that those banks which were not “*internationally-active*” were already sufficiently regulated by the laws of the US<sup>367</sup>.

Though the Basel regime did not define, or in any way outline the monetary thresholds which would define banks as being “*internationally-active*”, the thresholds for a bank to be considered as a “*core bank*” were established internally in the US, and were defended by the US regulators in light of the high-percentage of banking activity which was covered by the banks which fell within the said thresholds<sup>368</sup>. This results-based approach was therefore used to justify the monetary thresholds established, and though this has not caused issues with assessors from the BCBS (in its assessment of implementation of Basel in the US<sup>369</sup>), it is conceivable to argue that these same monetary thresholds may have different outcomes (in the percentage of banking activity regulated) if they were to be transplanted in other jurisdictions.

On implementing the more recent Basel III, the US opted to extend the scope as to which entities the Basel Accords would apply. The Basel III Final Rule on capital standards, issued in July 2013, established that the Basel III provisions, as implemented in the US, would apply to all depository institutions in the US (other than for small banks with less than USD500 million in assets), as well as to systemically important non-bank financial companies<sup>370</sup>. Since the US had previously only implemented the Advanced IRB approach, the new amendments specified that not all entities would be applying this approach, and banks which do not qualify under the Advanced IRB approach would adopt a method for calculation of capital built on the Standardised approach (with this method of calculation being established by US regulators, and not following the requirements set out by the Basel Accords)<sup>371</sup>. The Standardised approach will also, however, act as a “*capital-floor*”, with the capital requirements being increased according to an entity’s size and complexity<sup>372</sup>. Banks adopting the Advanced IRB approach are thus required to calculate their capital on the basis of both the

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<sup>367</sup> See: Roger W. Ferguson, Jr., *Basel II: A Realist’s Perspective* (Remarks at the Risk Management Association’s Conference on Capital Management, Washington D.C., 9 April 2003) (Ferguson RMA Conference); Roger W. Ferguson, Jr., *Basel II: Scope of Application in the United States* (Remarks before the Institute of International Bankers, New York, 10 June 2003) (Ferguson IIB Remarks); Ferguson (n 363).

<sup>368</sup> Ferguson IIB Remarks (n 367).

<sup>369</sup> US Regulatory Consistency Assessment (n 364).

<sup>370</sup> Rainer Masera, *US Basel III Final Rule on Banks’ Capital Requirements: a Different-Size-Fits-All Approach* (PSL Quarterly Review, Vol. 66, No. 267, 2013) 388 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2456196](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2456196)> accessed 14 December 2014.

<sup>371</sup> *ibid* 388 – 389.

<sup>372</sup> *ibid*.

Standardised approach and the Advanced IRB system, and they are then to use the most prudent approach for compliance purposes<sup>373</sup>.

The Basel III amendments in the US will therefore not apply to small banks with total consolidated assets of less than USD500 million, to non-covered savings and loan holding companies, and to holding companies of industrial loan companies (unless these are considered to be systemically important entities)<sup>374</sup>. These entities will continue to adopt regulatory capital requirements based upon the Basel I standards<sup>375</sup>. One should also note that community banks (which include commercial banks and savings and loan associations and which have total consolidated assets of less than USD15 billion (calculated as at December 2009)) will be subject to a less stringent regulatory framework, whilst being subject to certain grandfathering provisions with respect to the calculation of regulatory capital<sup>376</sup>.

Moreover, in the US, the liquidity coverage ratio will only apply to “*internationally active banking organizations*” (which are defined by referring to the same thresholds used on implementing Basel II, and with the liquidity coverage ratio therefore applying only to banks having total consolidated assets of USD250 billion or more, or having on-balance sheet foreign exposures amounting to USD10 billion or more), and to systemically important non-bank financial institutions<sup>377</sup>. A less stringent liquidity coverage ratio will apply to bank holding companies that have more than USD50 billion in total assets provided that they do not meet the aforementioned thresholds<sup>378</sup>.

Non-bank financial companies will only be subject to the rules implementing Basel III if these are considered as being “*systemically important*”<sup>379</sup>. Rules have been established, setting out a three-stage process through which non-bank financial companies are evaluated in order to determine whether they should be classified as “*systemically important*” or otherwise, depending on the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities carried out by the said entity<sup>380</sup>. However,

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<sup>373</sup> *ibid* 388 – 390.

<sup>374</sup> *ibid* (n 370) 389; Choulet (n 335) 4.

<sup>375</sup> Masera (n 370) 389.

<sup>376</sup> *ibid* 390; Choulet (n 335) 4.

<sup>377</sup> CIT Group Inc., CIT Bank, *CIT Annual Report 2013: Building Long-Term Value* (3 April 2014) 12 <<http://ir.cit.com/Cache/1001185620.PDF?Y=&O=PDF&D=&fid=1001185620&T=&iid=102820>> accessed 10 December 2014 (CIT Annual Report 2013).

<sup>378</sup> CIT Annual Report 2013 (n 377) 12.

<sup>379</sup> Masera (n 370) 388.

<sup>380</sup> See also: Financial Stability Oversight Council, ‘Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies’ (Office of the Federal Register of the

one of the initial conditions in order for a non-bank financial company to be classified as “*systemically important*”, is that it needs to at least have total consolidated assets amounting to USD50 billion (apart from other thresholds which would also need to be met)<sup>381</sup>.

### 3.4.3 Other Jurisdictional Inconsistencies in the Application of the Basel Accords

The position adopted by most jurisdictions has been that they have applied the Basel Accords, on a national level, to all banks found in that jurisdiction, without making any distinction between banks which are “*internationally-active*” or otherwise. The extension of the Basel Accords to investment firms varies from one jurisdiction to another. A few examples from the laws of different jurisdictions which implement the Basel Accords will be considered below.

In Canada, the Canadian Capital Adequacy Requirements Guideline was made applicable to all banks incorporated in Canada, as well as to trust and loan companies, irrespective of whether these entities are internationally-active, or otherwise<sup>382</sup>. Similarly, in Australia, the Prudential Standards implementing the Basel Accords apply to all “*authorised deposit-taking institutions*” incorporated in Australia (meaning that these standards apply also to small and medium-sized commercial banking institutions which might not be internationally-active)<sup>383</sup>. The term “*authorised deposit-taking institutions*” includes banks (both domestically owned as well as subsidiaries of overseas banks),

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National Archives and Records Administration, United States, 4 November 2012) <<https://www.federalregister.gov/articles/2012/04/11/2012-8627/authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies>> accessed 18 December 2014; Financial Stability Oversight Council, ‘Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies’ <<http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designations%20-%20Final%20Rule%20and%20Guidance.pdf>> accessed 18 December 2014; Chadbourne & Parke LLP, *How Can a Nonbank be Determined “Systemically Important”? Fed Finalizes Key Rules* (9 April 2013) <<http://hb.betterregulation.com/external/How%20Can%20a%20Nonbank%20be%20Determined%20Systemically%20Important%20Fed%20Finalizes%20Key%20Rules%20-%2009%20Apr%2013.pdf>> accessed 18 December 2014.

<sup>381</sup> Masera (n 370) 388.

<sup>382</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Regulations – Canada* (July 2014) 4 <[http://www.bis.org/bcbs/implementation/l2\\_ca.pdf](http://www.bis.org/bcbs/implementation/l2_ca.pdf)> accessed 12 December 2014 (Canada Regulatory Consistency Assessment).

<sup>383</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Regulations – Australia* (March 2014) 3 – 4 <[http://www.bis.org/bcbs/implementation/l2\\_au.pdf](http://www.bis.org/bcbs/implementation/l2_au.pdf)> accessed 12 December 2014 (Australia Regulatory Consistency Assessment).

branches of overseas banks, credit unions, building societies, providers of purchased payment facilities, and specialist credit card providers<sup>384</sup>.

In the People's Republic of China, the relevant capital rules apply to all registered commercial banks – including small and medium-sized commercial banks which are not “*internationally-active*”<sup>385</sup>. These rules do not apply, however, to “*policy banks*”, which are non-deposit taking, state-guaranteed investment entities<sup>386</sup>.

The Capital Regulations of Brazil apply to all “*financial institutions*”, whether these are considered to be “*internationally-active*” or otherwise<sup>387</sup>. The term “*financial institutions*” is very widely defined by Article 17 of the Brazilian Banking Law (Law 4595/1964), and refers to “*public or private corporate persons that have as their major or accessory activity the gathering, intermediation or investment of their own or third party financial resources in national or foreign currency, and custody services of assets belonging to third parties*”<sup>388</sup>. The applicability of the regulations implementing the Basel Accords are therefore similar to those found in the EU given that they are extended to institutions which also assist in the investment of their own or of third party financial resources.

In Switzerland, the main legislative text for the regulation of capital standards and implementation of the Basel Accords is the Capital Adequacy Ordinance<sup>389</sup>. This

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<sup>384</sup> *ibid*; See also: <<http://www.apra.gov.au/adi/pages/adilist.aspx>> accessed 13 December 2014.

<sup>385</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Regulations – China* (September 2013) 6 <[http://www.bis.org/bcbs/implementation/l2\\_cn.pdf](http://www.bis.org/bcbs/implementation/l2_cn.pdf)> accessed 12 December 2014 (China Regulatory Consistency Assessment).

<sup>386</sup> *ibid*.

<sup>387</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Regulations in Brazil* (December 2013) 59 <[http://www.bis.org/bcbs/implementation/l2\\_br.pdf](http://www.bis.org/bcbs/implementation/l2_br.pdf)> accessed 12 December 2014 (Brazil Regulatory Consistency Assessment).

<sup>388</sup> The definition continues by extending the applicability of the definition of ‘financial institutions’ also to natural persons who carry out the functions of financial institutions; Article 17, Law No. 4,595 dated December 31, 1964 <<http://www.bcb.gov.br/?LAW4595>> accessed 13 December 2014; See also: International Monetary Fund, *Brazil: Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision* (IMF Country Report No. 12/207, July 2012) 22 <<http://www.imf.org/external/pubs/ft/scr/2012/cr12207.pdf>> accessed 13 December 2014 (IMF Brazil Report).

<sup>389</sup> Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III Regulations – Switzerland* (June 2013) 5 <[http://www.bis.org/bcbs/implementation/l2\\_ch.pdf](http://www.bis.org/bcbs/implementation/l2_ch.pdf)> accessed 12 December 2014 (Switzerland Regulatory Consistency Assessment).

Ordinance makes the capital adequacy rules applicable to both “banks” as well as “securities dealers”<sup>390</sup>.

On the other hand, in Japan, only “internationally-active banks” are obliged to comply with the rules implementing the Basel Accords<sup>391</sup>. A separate regime was however established for “domestic banks”, with much less capital requirements being required (having a minimum capital adequacy ratio of 4 per cent, with various reserves being included in the regulatory capital)<sup>392</sup>. One should also note that in Japan banks are considered to be “internationally-active” only if they have overseas subsidiaries or branches, notwithstanding that “domestic banks” might be active in foreign markets without having established subsidiaries or branches outside of Japan<sup>393</sup>. The definition of “internationally-active” is therefore substantially different from that which had been adopted in the US (which referred to specific financial thresholds as discussed above). Furthermore, though the US has now limited the difference in applicability between internationally active banks and other banks, Japan has opted to retain its distinction between “internationally-active banks” and other banks.

### ***3.5 Competitive Equity and the Changing Objectives of the Basel Accords***

As discussed in the preceding Sections the lack of definitions in the international standards established by the Basel Accords has led to these standards being applied to different entities in different jurisdictions. Though the Basel Accords refer to

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<sup>390</sup> Article 3, Capital Adequacy Ordinance <<http://www.admin.ch/opc/fr/classified-compilation/20121146/index.html>> accessed 13 December 2014; KPMG, ‘Capital Adequacy Ordinance CAO 952.03’ <<https://www.kpmg.com/CH/en/Library/Legislative-Texts/Documents/pub-20122-circular-cao-92503-en.pdf>> accessed 13 December 2013; See also: Swiss National Bank, ‘Capital Adequacy Reporting Form in the Context of Basel III’ <<http://www.snb.ch/en/emi/basel3>> accessed 13 December 2014.

<sup>391</sup> Hyoungh-kyu Chey (n 122) 72; International Monetary Fund, *Japan: Basel Core Principles for Effective Banking Supervision – Detailed Assessment of Compliance* (IMF Country Report No. 12/231, August 2012) 52 – 55 <<http://www.imf.org/external/pubs/ft/scr/2012/cr12231.pdf>> accessed 13 December 2014 (IMF Japan Report).

<sup>392</sup> *ibid*; See also: Toshikazu Sakai, *The Implementation of the Basel III Guidelines in Japan* (Banking, Finance and Capital Markets Law Commission, 52<sup>nd</sup> Annual AIJA Congress, Prague, Bingham Sakai Mimura Aizawa, 2014) <<http://prague.aija.org/wp-content/uploads/2014/04/Presentation-Toshikazu-Sakai.pdf>> accessed 13 December 2014; Basel Committee on Banking Supervision, *Basel III Regulatory Consistency Assessment (Level 2) – Japan* (October 2012) 16 <[http://www.bis.org/bcbs/implementation/12\\_jp.pdf](http://www.bis.org/bcbs/implementation/12_jp.pdf)> accessed 12 December 2014 (Japan Regulatory Consistency Assessment).

<sup>393</sup> Hyoungh-kyu Chey (n 122) 72; IMF Japan Report (n 391) 52 – 55; Japan Regulatory Consistency Assessment (n 392) 13.

*“internationally-active banks”*, in the EU these international standards have been applied to all banks and investment firms, whilst in the US they have only recently been extended to most *“depository institutions”* (whilst applying a watered-down regime for smaller banks) and are only applied to those non-banks which are considered to be systemically important.

In considering the scope of implementation of Basel II, the US had discussed the need for *“competitive equity”* between banks and non-banks, and though it was recognised that disparities between bank regulation and non-bank regulation should be avoided, it was also considered that supervisors have *“an obligation to develop the regulations that they feel are appropriate to banks even if similar regulations will not be applied to nonbank competitors”*<sup>394</sup>. Furthermore the main focus of US regulation has been limited to internationally-active banks and systemically important financial institutions, notwithstanding that the three types of capital adequacy standards (i.e. the Standardised, Foundation IRB, and the Advanced IRB approaches) put forward in the Basel Accords as from Basel II were meant to apply not only to the most complex of banks, but to a wide range of banks and financial institutions irrespective of their activities and complexity<sup>395</sup>.

The need for *“competitive equity”* between different financial entities has been discussed in both the EU and the US, whilst seeking to justify their different approaches as to which entities the Basel Accords should be applied to<sup>396</sup>. It seems somewhat ironic, therefore, that the same argument was used in different jurisdictions to justify completely different approaches. In the EU the argument of *“competitive equity”* was used in order to argue in favour of the extension of the capital requirements directives and the CRR to all of internationally-active credit institutions, credit institutions which are not internationally-active, as well as investment firms (even though the EU is yet to adopt this reasoning in relation to shadow banks)<sup>397</sup>. On the other hand, this was used in the US in order to argue that, in light of the higher costs which the Basel regime imposed on banks, competitive equity required that the Basel regime should only apply to larger banks since otherwise smaller banks would be subject to disproportionate costs on implementation of the laws implementing the Basel Accords and would thus find

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<sup>394</sup> Ferguson RMA Conference (n 367).

<sup>395</sup> Herring (n 355) 276.

<sup>396</sup> Masera (n 356) 11.

<sup>397</sup> Lucia Quaglia, *Setting the Pace? Private Financial Interests and European Financial Market Integration* (British Journal of Politics and International Relations, Wiley-Blackwell, 2008) 57.



themselves at a competitive disadvantage<sup>398</sup>. It was also argued by US policymakers that large banks are not only able to absorb the high costs which the Basel regime imposes, but they are also better equipped to circumvent the regulations through the use of sophisticated derivative-based financial structures<sup>399</sup>.

Whereas “*competitive equity*” was the reason why capital requirements were extended to investment firms in the EU, no consideration has been given to the possibility of extending the principles of the Basel Accords to shadow banking entities. This has also been highlighted as a point of concern by the Banking Stakeholder Group who have stated that<sup>400</sup>:

*there is a potential danger that the overall regulatory regime that is applied to regulated banks may not be as sufficiently competitively neutral as between institutions conducting essentially similar business and that this may unnecessarily distort competition between the regulated sector and the less-regulated institutions in the shadow banking sector.*

Moreover, the definition of “*internationally-active*” itself has also been the subject of different interpretations, with the US and Japan adopting different arbitrary definitions which are not consistent with each other and which have therefore given rise to inconsistencies in the way in which the Basel Accords are applied internationally.

One must therefore take a closer look at the objectives of the Basel Accords, particularly in light of varying reasons for regulation which have been given on adoption of these standards on a national level. As seen in this Section, the historical reason for the implementation of the Basel Accords has been attributed to the need for a level playing field amongst banks in different jurisdictions, thus ensuring that international banks competing with each other are subject to similar regulatory frameworks. This can also be seen from the text of Basel I, which stated: “*This report represents the outcome of the Committee’s work over several years to secure **international convergence** of supervisory regulations governing the capital adequacy of international banks*” [emphasis added]<sup>401</sup>.

Following the recent global financial crisis the main objective of the Basel Accords seems to have been changing, however, with priority being given to objectives other than that of having “*regulatory convergence*” between states. Basel I had listed two “*fundamental*

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<sup>398</sup> Masera (n 356) 11.

<sup>399</sup> *ibid.*

<sup>400</sup> European Banking Authority (n 328) 37.

<sup>401</sup> Basel I (n 261) 1 para. 1.



objectives” which “lie at the heart of the Committee’s work”, in seeking to obtain regulatory convergence<sup>402</sup>:

*Two fundamental objectives lie at the heart of the Committee’s work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be in fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks...*

Therefore, in Basel I, regulatory convergence had been set as the main aim of the Basel Accords, with this having been sought through the attainment of two “fundamental” objectives. The two objectives which were considered necessary to reach regulatory convergence, were: strengthening the soundness and stability of the international banking system; and having a higher degree of consistency of the regulatory framework.

However, following the recent global financial crisis there has been a shift in emphasis from “regulatory convergence” towards seeking to reduce systemic risks by placing a greater emphasis on the soundness of banking systems (which in Basel I was only considered as a “fundamental objective” in achieving the main goal of regulatory convergence). The title of the Basel documents itself is evidence of this. Whereas each of the Basel I and Basel II texts were given the title of “*International Convergence of Capital Measurement and Capital Standards*”, the main Basel III documents (which amended (but did not replace) the Basel II text) were entitled: “*Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*” and “*Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*” respectively.

Regulatory capital in Basel III is therefore now seen as a means through which systemic risks may be contained, rather than being used to ensure that similar standards apply between different states and thereby reducing competitive advantages which certain states would otherwise have over others<sup>403</sup>. The aim of countering systemic risks also appears to contrast with the position adopted prior to the recent global financial crisis – where the former Federal Reserve Chairman Alan Greenspan had stated that the containment and elimination of systemic risks should be a function of central banks, and should not be catered for through the imposition of capital adequacy measures on

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<sup>402</sup> *ibid* 1 para. 3.

<sup>403</sup> See: Hal S. Scott, *Reducing Systemic Risk through the Reform of Capital Regulation* (Journal of International Economic Law, Vol. 13(3), OUP, 2010) 763 – 764.

banks<sup>404</sup>. Moreover, the Basel Accords now also seek to minimise systemic risk at a national level (rather than just focusing on systemic risks arising out of the international banking system), such that the Basel Accords have been seen as a system through which banks are strengthened in order to seek to ensure that claims on public funds (through depositor insurance/ guarantee schemes) are not resorted to.

The shift in scope away from regulatory convergence seemed to already be present in Basel II – when referring to the ways in which supervisory authorities should have adopted Basel II it was specifically stated that on implementation of the Basel Accords national supervisors needed to carefully consider the benefits which Basel II would have had at national level and therefore develop a timetable and approach to implementation based on national considerations<sup>405</sup>. This also shows a shift away from the objective of regulatory convergence, towards a system where the resilience and soundness of banks (through the adoption of stronger risk management practices) seeks to take precedence.

As early as 2003, the Vice Chairman of the Federal Reserve Board had already stated, on discussing Basel II, that “[m]any have forgotten that the first accord had its origins in complaints that globalization of banking had distorted competitive balance...”<sup>406</sup>. He continued by stating: “[w]e should not lose sight of the continuing imperative, both economic and political, to ensure that a revised accord is perceived by all to maintain a level playing field for banks operating not only across national borders but also domestically”<sup>407</sup>.

In setting out its objectives, Basel II already implied that “sufficient consistency” amongst the laws and regulations of different jurisdictions will suffice, as long as the soundness and stability of the international banking system is catered for. In this respect Basel II stated<sup>408</sup>:

*The fundamental objective of the Committee’s work to revise the 1988 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.*

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<sup>404</sup> Tarullo (n 21) 22.

<sup>405</sup> Basel II (n 264) 1 para. 3.

<sup>406</sup> Ferguson (n 363).

<sup>407</sup> *ibid.*

<sup>408</sup> Basel II (n 264) 2 para. 4.

The Basel III reforms' main objectives, following the recent global financial crisis, continued to build on Basel II, by having their main objectives strictly focused on the reduction of systemic risks, by stating that “[t]he objective of the reforms is to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy”<sup>409</sup>. It has also been stated that a number of reforms in Basel III were introduced in order to “address the market failures revealed by the crisis”<sup>410</sup>.

Therefore, whilst international regulatory convergence was the main reason for the promulgation of the Basel Accords, there has been, in recent years, a marked shift away from the original objective of international regulatory convergence, towards the protection from systemic risks and the “soundness and stability of the international banking system”. This shift in scope away from regulatory convergence, and similarly the lack of competitive equity between different financial instruments has however increased regulatory arbitrage opportunities available, which may in turn even defeat the purpose of reducing systemic risks, as will be discussed in further detail in Chapter 5.

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<sup>409</sup> Basel III, 2010 (n 35) 1 para. 1.

<sup>410</sup> *ibid* 2 para. 6.

## Chapter 4: Applying Economic Concepts to the Basel Accords

In Chapter 2 of this thesis it has been shown how the Basel Accords developed primarily through regulatory cooperation and transnational regulatory networks, with the regulatory agencies responsible for developing this transnational regulation being subject to various influences. This Chapter will start off by reviewing literature which sets out main law and economics principles, and Section 4.2 will then proceed to apply these principles to the Basel Accords. It will here be shown that insufficient economic analysis has been carried out on formulating the Basel Accords, with this giving rise to legitimacy and accountability problems<sup>411</sup>. In the following Chapter it will also be argued this has given rise to problems of regulatory arbitrage which limit the positive effects which the Basel Accords seek to achieve, and with regulatory arbitrage being encouraged as a result of the different approaches being adopted by different jurisdictions and as a result of the Basel Accords being extended to different types of entities across different jurisdictions as described in Chapter 3.

### 4.1 Main Economic Concepts

According to Waller, law and economics “*applies economic reasoning to legal questions and in general views the creation and enforcement of legal rules primarily in terms of how legal rules and institutions promote allocative efficiency and wealth maximization*”<sup>412</sup>. He states that “*law and economics examines and evaluates the changes generated in respect of one variable, human behaviour, in dependence and as a function of another variable, legal rules*”, and this whilst other determinants are assumed to remain constant<sup>413</sup>. Different actors therefore continuously seek to maximize their utility, particularly by responding to incentives and changes in regulation from time to time, such that one necessarily needs to understand the utility obtained by the different actors in order to predict what

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<sup>411</sup> The lack of a law and economics approach is not surprising given the relatively recent rise in the importance of this subject-matter. Cooter has noted how until recently “*law confined the use of economics to antitrust, regulated industries, tax, and monetary changes*”, and that as from the 1960s, “*economic analysis of law expanded remarkably by its application to property, contracts, torts, crimes, procedure, and constitutional law*”. Furthermore, relevant debates over the application of economic principles to international financial regulation (particularly when this is implemented as a transnational regulatory law) are still very limited; Cooter 1995 (n 14) 50.

<sup>412</sup> Spencer Weber Waller, *The Law and Economics Virus* (Cardozo Law Review, Vol. 31, 2009 – 2010) 367.

<sup>413</sup> Michael Schillig, *The Contribution of Law and Economics as a Method of Legal Reasoning in European Private Law* (European Review of Private Law, Vol. 17 Issue 5, 2009) 857.

effect certain regulation (and transnational regulatory laws) may have upon these actors, and how they would react to a change in regulation.

Jolls, Sunstein and Thaler have stated that the goal of law and economics is to explain the content of law, and that law could have been established for two different reasons<sup>414</sup>: since laws can be seen as solutions to the problems which arise in trying to organize society, they may provide efficient solutions to organizing society; and on the other hand, laws may be enacted because of rent-seeking activities of politically-powerful actors. In this regard Schillig has noted that “[l]aw as a means to an end aims to generate (or to preserve) a certain state of affairs in the world, to yield certain consequences, by providing a set of incentives for those subject to legal rules so that they may adjust their behaviour accordingly”<sup>415</sup>. He however also observes how the ends which are pursued by the legislator are only achieved if the addressees of rules do actually adjust their behaviour in the way in which the legislator would have intended<sup>416</sup>.

#### **4.1.1 Law as a Sanction or Constraint**

Schillig, quoting Posner, has stated that “[e]conomics is the science of rational choice in a world – our world – in which resources are limited in relation to human wants”, and he therefore considers that “economics provides a theory of human behavior as a function of external constraints”, and that as a result law “is part of the constraints that restrict the individual’s free choice and necessitate the allocation of scarce resources to competing ends”<sup>417</sup>. He continues by stating that economic analysis of law thus<sup>418</sup>:

*explores whether and in what way changes to the law – by way of legislation or adjudication – are likely to influence the behaviour of those subject to the law and, given certain pre-determined policy objectives, which regulatory or interpretative alternative appears to be preferable.*

Law as a “constraint” is very relevant to the Basel Accords given that these international standards act as a constraint not only on the industry, but also on the same states which are meant to implement and enforce the Basel Accords. This thesis has considered, in Section 2.3, how the three actors involved in the Basel Accords consist of national regulatory agencies which come together as a transnational network; the individual

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<sup>414</sup> Christine Jolls, Cass R Sunstein and Richard Thaler, *A Behavioural Approach to Law and Economics* (Stanford Law Review, Vol. 50, No. 5, May 1998) 39.

<sup>415</sup> Schillig (n 413) 866.

<sup>416</sup> *ibid.*

<sup>417</sup> *ibid.*

<sup>418</sup> *ibid* 857.

nation states which typically act out of self-interest; and the industry, which is not necessarily concerned with transnational problems. As the industry and states are subject to the limitations established by the Basel Accords, both of these actors are conditioned to make rational choices which may help them reach their specific goals and which may defeat the aims for which the Basel Accords had been established by the international community made up of transnational bodies and transnational networks.

Economic theory, as applied to law, provides a behavioural theory which seeks to explain and predict how people (or in relation to the Basel Accords, firms, or states) respond to incentives or disincentives which are created by legal rules and institutions<sup>419</sup>. Cooter notes how the “*imperative theory of law defines a law as an obligation backed by a sanction*” and that economic analysis has “*enjoyed great success by analyzing a legal sanction as if it were a market price*”<sup>420</sup>. Similarly, Korokbin and Ulen have stated that the “*seminal insight that economics provides to the analysis of law is that people respond to incentives*”, with this therefore being based, as a concept on the price theory<sup>421</sup>.

Economic analysis has thus sought to predict the effect of sanctions upon one’s behaviour, and has considered how “*sanctions*” (including those arising from law and regulation) have the same effect as “*prices*” as they are both tariffs on behaviours, and given that people respond to heavier sanctions in the same way as they would respond to higher prices<sup>422</sup>. Thus, in carrying out an economic analysis of law, economists have sought to adapt “*price theory*” to law in order to seek to determine the behavioural effects as to how people respond to sanctions imposed upon them by law and regulation<sup>423</sup>. This thesis will therefore consider the behaviour of states and of the industry as a result of sanctions and limitations imposed by the Basel Accords, and it will be argued that regulatory arbitrage takes place as states and the industry act out of self-interest.

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<sup>419</sup> Cooter and Kraus (n 14) 26.

<sup>420</sup> Cooter notes how an actor can either see a sanction as a price or as an external constraint, or alternatively if many people in a community internalize such an obligation this would become a “*social norm*”. Thus a rational person may also internalize a norm when this may convey an advantage over one’s original preferences, with Cooter referring to this as resulting in a “*Pareto self-improvement*”. Thus, by creating opportunities for Pareto self-improvements, law may induce rational people to change their preferences; Cooter (n 14) 2.

<sup>421</sup> Russell B Korokbin and Thomas S Ulen, *Law and Behavioural Science: Removing the Rationality Assumption from Law and Economics* (California Law Review, Vol. 88, No. 4, July 2000) 1054.

<sup>422</sup> Cooter (n 14) 2, 51 – 52.

<sup>423</sup> *ibid* 52.

Cooter further notes that when analyzing the effect which sanctions have on one's behaviour, one also needs to analyse whether the subjects of law or regulation behave "*strategically*" or "*non-strategically*"<sup>424</sup>. Though the main assumption behind price theory is that people behave non-strategically (with each participant expecting that his own buying and selling would not affect the market), there may be instances where participants do adopt a strategic approach<sup>425</sup>. When participants adopt a strategic approach, "*game theory*" is resorted to in order to analyse how participants adopt strategic behaviour in response to changes in the applicable rules, with one's actions being dependent upon the envisaged reaction which other participants may have<sup>426</sup>. It has been noted that whether people behave strategically or otherwise will often depend on the number of participants in the market, given that where there are a larger number of participants one would assume that one's actions alone cannot influence the "*market*" (as in a perfectly competitive model), whilst where there are very few participants each one may assume that his behaviour can affect the activities of other participants<sup>427</sup>.

This thesis argues that when considering the Basel Accords, states (as actors and as entities which are regulated by transnational regulatory laws) behave strategically in adopting, implementing and enforcing the Basel Accords, with this being a result of the regulatory competitive environment which states find themselves in.

#### **4.1.2 Maximising Utility**

As the goals of the international community, of states, and of financing entities vary, the utility these different players derive from a transnational regulatory law such as the Basel Accords varies also. Cooter and Kraus have noted how one combines goods into bundles in order to make overall judgments about whether one bundle is better than another, with this being the meaning behind the term "*utility*"<sup>428</sup>. In light of limited resources and of different alternatives available (giving rise to different utility), a rational person would make those choices which would realise such person's overall goal<sup>429</sup>. They therefore state that this is "*all that modern economists mean by an individual "maximizing utility"*"<sup>430</sup>.

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<sup>424</sup> *ibid.*

<sup>425</sup> *ibid.*

<sup>426</sup> *ibid.*

<sup>427</sup> *ibid.*

<sup>428</sup> Cooter and Kraus (n 14) 19.

<sup>429</sup> *ibid* 19 - 20.

<sup>430</sup> *ibid* 20.

Schillig has similarly noted how the concept of “*utility maximization*” is that “*human behaviour is based on the idea that individuals seek their own interest as they perceive it and maximize their utility subject to constraints imposed on them by existing normative systems and factual determinants*”<sup>431</sup>. He however notes how this rests on three basic assumptions, being: one ranks alternative combinations according to preference orders; there are limited resources (scarceness) which restrict the alternatives available; and one’s choices are a function of his preferences and constraints<sup>432</sup>. One’s rationality is however “*bounded*” by constraints such as transaction costs, information costs, as well as by one’s limits of processing the information available<sup>433</sup>. Given that one only has limited resources available, a consumer is considered to maximise his utility by choosing the consumption which best serves his preferences<sup>434</sup>. One’s utility is considered to be maximised when the marginal benefit obtained from the additional unit is equal to the marginal costs represented by the loss in utility resulting from the foregone opportunity of investing in alternative goods<sup>435</sup>.

Furthermore, Cooter and Kraus also note that economists usually assume that consumers get their utility from their own consumption of goods and not from consumption of goods by others, and that consumers are therefore purely “*self-interested*”, and that “*narrow self-interest*” remains “*the operate assumption*” in areas of “*applied economics, such as international trade, industrial organization, and finance*”<sup>436</sup>. Economists also assume that persons only care about their own wealth or well-being and not about the wealth or well-being of others, with this therefore complementing the self-interest attributes referred to above<sup>437</sup>.

As the thesis considers the different goals of the different actors, it argues (particularly in Section 2.3) that the different actors in the Basel Accords’ recursive process act out of self-interest and that the goals of each of the international community, the states, and of the financing entities vary due to their own self-interest and out of their interest to maximize their own individual utility. This thesis therefore looks at the effect of firms and states adopting a “*rational*” approach to the Basel Accords, with firms and states

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<sup>431</sup> Schillig (n 413) 857 – 858.

<sup>432</sup> *ibid* 858.

<sup>433</sup> *ibid*.

<sup>434</sup> *ibid* 859.

<sup>435</sup> *ibid*.

<sup>436</sup> Cooter and Kraus (n 14) 21 - 22.

<sup>437</sup> *ibid* 21.



therefore acting out of their own “*self-interest*” in seeking to attain their specific goals, rather than as “*reasonable*” entities<sup>438</sup>.

#### **4.1.3 Efficiency in the Allocation of Property Rights and the Justifiability of Regulatory Intervention**

As seen above, rational actors seek to maximize their utility through the actions they take. As a corollary of this, Coase has argued that notwithstanding the initial distribution of property rights, bargaining and trading among right holders will inevitably lead to property rights being allocated efficiently<sup>439</sup>. He notes that the precondition for this to be able to take place is that property rights must be clearly defined, transaction costs (and information costs) must be close to zero, there must be no wealth effects which will affect marginal valuation, and with strategic behaviour and free-riding also being ruled out<sup>440</sup>.

As a result, Schillig has argued that a conclusion which may be drawn from the Coase Theorem is that<sup>441</sup>:

*[r]egulatory intervention may be justified only when market failure reaches a degree and transaction costs reach a level which effectively prevents efficient exchange based on bargaining and negotiation. Any regulatory intervention should be carried out only if, and to the extent that, its benefits outweigh its inevitable costs.*

Following on from the Coase Theorem it has been argued that the visible hand of the law (which therefore includes governance mechanisms such as public laws, regulations and business associations) improves economic performance only through its ability to reduce transaction costs<sup>442</sup>.

When considering the particular nature of the Basel Accords, however, one needs to consider to what extent transaction costs are reduced and whether the Basel Accords can therefore be justified or otherwise. One can argue that the limitations imposed by

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<sup>438</sup> Cooter and Kraus distinguish between law, which assumes that people act reasonably and the ideal economic decision-maker who is perfectly rational. See: Cooter and Kraus (n 14) 23; Cooter (n 14) 62.

<sup>439</sup> Ronald H Coase, ‘The Problem of Social Cost’ in Donald A Witman (ed), *Economic Analysis of Law* (Blackwell Publishing Ltd, 2003) 4 – 10; Schillig (n 413) 863.

<sup>440</sup> Coase (n 439) 10 – 12; Schillig (n 413) 863.

<sup>441</sup> Schillig (n 413) 865.

<sup>442</sup> Matthew Beville, Dino Falaschetti and Michael J Orlando, *An Information Market Proposal for Regulating Systemic Risk* (24 August 2009) 8 – 9 <<http://ssrn.com/abstract=1443268>> accessed 24 January 2016.

the Basel Accords increase rather than reduce transaction costs and that the aim of the international community is only to reduce potential social costs which may arise in the long run on the happening of financial crises (and which the Basel Accords seek to prevent). In light of the limited scope of the Basel Accords (as described in Chapter 3), regulatory arbitrage has been resorted to, resulting in the transfer of risk from the regulated to the unregulated activities (such as through entities such as shadow banks), which may therefore even bring into question whether the social costs which the Basel Accords seek to prevent are actually being prevented or otherwise.

#### ***4.2 Extending Concepts of Law and Economics to the Basel Accords***

Notwithstanding that literature on law and economics generally refers to the concept of law and economics when considering how national law applies to individuals and firms, these concepts can also be extended to transnational regulatory laws such as the Basel Accords. Transnational regulatory laws act as a constraint not only on individuals and firms, but also on states (in their role as “actors”). Both states as well as the industry (as further described in Section 2.3.2) have their own goals to achieve, which may be different from the goals of the international community, and these goals may also change in response to further constraints imposed upon them.

It is here argued that the Basel Accords will only reach their stated aims if they can be seen as emanating from a legitimate body by each of the international community, states, and the industry, and only if the objectives of the Basel Accords do not hinder the goals of each of these three different actors. In order to have effective regulation of systemic risks and capital adequacy an analysis needs to be carried out of how the different actors are affected by the Basel Accords, who these different actors are and what their goals are, and how they would be expected to act if they are to act as rational actors seeking to maximize their own utility.

Both the industry as well as states (acting independently from the international community), do not necessarily have global financial stability, the reduction of systemic risk, or regulatory convergence amongst different states, as their main areas of priority. Rather, one can safely assume that the main priority of industry participants (regulated by the Basel Accords) is that of making profits to the satisfaction of their shareholders or promoters. Furthermore, one can also assume that the main interest of individual states is that of having a competitive advantage over other states in order to attract and encourage investment and provide for the well-being of their citizens (also since states obtain their own legitimacy from their citizens). These specific goals of the industry and

of individual nation states may therefore be conflicting with the goals of the international community which gets together to set out the Basel Accords.

Goldsmith and Posner have argued that the development of “*international law*” is not based on “*legality, morality, opinio juris, and related non-instrumental concepts*” but rather on “*rational choice tools*”<sup>443</sup>. They argue that international law develops as a result of states seeking to rationally “*maximize their interests*” (as states) given their perception of the varying interests of other states, and the distribution of power amongst different states<sup>444</sup>. They also argue that states have “*no moral obligation to comply with international law, and liberal democratic nations have no duty to engage in the strong cosmopolitan actions so often demanded of them*”<sup>445</sup>.

The varying goals of the international community, the individual states, and of the industry also need to be analysed since the Basel Accords are only based on “*soft-law*” and would therefore be dependent on the individual states to be given effect to and to be supervised and enforced. Furthermore, the promulgation of transnational regulatory laws (including the Basel Accords) is typically dependent on a number of external factors and influences such as regulatory capture. As regulatory capture can affect the way in which regulatory agencies work, it can also influence the way in which transnational regulatory laws such as the Basel Accords are implemented and enforced in particular jurisdictions, possibly also by bringing the interests of the industry and of the individual nation states closer to each other (and further away from the interests of the international community). This will also be bound to be exacerbated by cultural and domestic embeddedness which would typically only affect the industry and national regulatory agencies, drawing them even closer to each other.

Moreover, hegemonic influences during negotiations leading up to the Basel Accords (and with similar influences also being applied on trying to encourage other jurisdictions to adopt these standards), also mean that certain states may not be willing to fully implement or enforce certain provisions of the Basel Accords. States may thus be willing to agree to the adoption of certain principles in the Basel Accords, in full knowledge that the texts agreed to here are only “*soft-laws*” and do not necessarily bind their future actions. The Basel regime is dependent on being implemented into national

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<sup>443</sup> Jack Goldsmith and Eric A Posner, *The New International Law Scholarship* (Georgia Journal of International and Comparative Law, Vol 34, Public Law and Legal Theory Working Paper No. 126, May 2006) 463.

<sup>444</sup> *ibid.*

<sup>445</sup> *ibid* 463, 472.

implementing laws, meaning that various issues are left to national supervisory discretion, and divergences are common, with different rules also being applied in different jurisdictions (though divergences in the EU are limited in light of there being a unified set of laws applied at EU level)<sup>446</sup>. These variations and limitations have also been recognised by the BCBS<sup>447</sup>.

Posner has also noted how, notwithstanding the long history of capital adequacy, bank regulators have rarely carried out any cost-benefit analyses on capital adequacy rules, and when a cost-benefit analysis was carried out by the BCBS this was carried out wrongly<sup>448</sup>. He has therefore argued that capital adequacy standards have only been adopted through a system which he calls “*norming*”, whereby regulators selected the “*mean or model behaviour*” of regulated entities and adopted that as a standard, thereby necessarily requiring a change in the behaviour of weaker banks which as a result were required to either increase their capital standards or stop operating<sup>449</sup>. He notes how between 1981 and 2013 capital requirements were raised “*slowly and reluctantly*” and as a “*response to the problem of regulatory arbitrage*”<sup>450</sup>. He argues that the capital adequacy requirements as introduced in the US were not based on proper cost-benefit analyses, and that the amendments made were only introduced as a reaction to periods of instability or periods of financial health and that “*regulators therefore acted like a person in a shower who turns the faucet toward hot if the water is too cold and turns the faucet toward cold if the water is too hot*”<sup>451</sup>.

Posner has argued that another standard which regulators seem to have adopted in establishing the capital adequacy regulation is that of “*feasibility*”, thereby seeking to ensure that regulation did not impose excessive costs which could have resulted in job losses, bankruptcy and factory shutdowns<sup>452</sup>. He however notes that “*feasibility*”, as a style of regulation, is less aggressive than what cost-benefit implies, and that regulators

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<sup>446</sup> Tarullo (n 21) 212; Wood (n 1) 663 – 664.

<sup>447</sup> Basel Committee on Banking Supervision, *Basel Capital Framework National Discretions* (November 2014) <<http://www.bis.org/bcbs/publ/d297.pdf>> accessed 19 November 2014;

<sup>448</sup> Eric A Posner, *How Do Bank Regulators Determine Capital Adequacy Requirements?* (Coase-Sandor Institute for Law and Economics Working Paper No. 698 (2D Series), September 2014) 3 <[http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2370&context=law\\_and\\_economics](http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2370&context=law_and_economics)> accessed 22 February 2016.

<sup>449</sup> *ibid.*

<sup>450</sup> *ibid* 19 – 23, 26.

<sup>451</sup> *ibid* 30.

<sup>452</sup> *ibid* 30 – 31.

seem to have been driven by the notion of imposing as little cost as possible over the industry<sup>453</sup>.

It has furthermore also been argued that the assumptions underlying the Basel regulatory risk capital weight function are not substantiated, and are mostly based on intuition (having been made arbitrarily) rather than following a scientific approach<sup>454</sup>. Benston has also stated that the standardised risk-weights adopted are not economically optimal, and these risk weights only represent a political compromise, where low risk-weightings are assigned to assets favoured by politically powerful groups<sup>455</sup>. It has also been argued that the regulatory model adopted by the Standardised approach ignores other matters, such as the effect of government intervention (such as through deposit insurance and bailouts) on bank risk taking<sup>456</sup>.

Prior to the adoption of Basel III, and the CRR and the CRD IV (in the EU), the economic analyses which were carried out by the BCBS<sup>457</sup>, and by other entities such as the European Central Bank<sup>458</sup> (“ECB”) and the UK Prudential Regulation Authority<sup>459</sup> (“PRA”), limited their scope to the additional elements introduced by Basel III (and consequently the CRR and the CRD IV), but did not analyse the major concepts upon which the Basel Accords have been developed and which are highlighted and questioned by this thesis. Therefore, notwithstanding the various restrictions imposed on the industry as a result of the Basel Accords, no proper economic analysis has been carried out despite the widespread economic implications of these international standards. Some of the economic considerations which one would have expected regulators to analyse on adopting and implementing the Basel Accords are: the loss of profits incurred

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<sup>453</sup> *ibid* 31.

<sup>454</sup> Gabbi Giampaolo, Vozzella Pietro *Asset Correlations and Bank Capital Adequacy* (The European Journal of Finance, Vol. 19, Issue 1, 2012) 55; Schooner (n 179) 168; Tarullo (n 21) 5.

<sup>455</sup> Schooner (n 179) 168.

<sup>456</sup> Gornall William, Strebulaev Ilya A., *Financing as a Supply Chain: The Capital Structure of Banks and Borrowers* (National Bureau of Economic Research, NBER Working Paper Series, Working Paper 19633, 2013) 43 – 44.

<sup>457</sup> Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (Bank for International Settlements, August 2010) <<http://www.bis.org/publ/bcbs173.pdf>> accessed 10 September 2017.

<sup>458</sup> European Central Bank, *The Impact of the CRR and the CRD IV on Bank Financing: Eurosystem Response to the DG FISMA Consultation Paper* (December 2015) <[https://www.ecb.europa.eu/pub/pdf/other/impact\\_of\\_the\\_crr\\_and\\_crd\\_iv\\_on\\_bank\\_financing.en.pdf?88c21ee4d8283b0cbd89a25700b32cda](https://www.ecb.europa.eu/pub/pdf/other/impact_of_the_crr_and_crd_iv_on_bank_financing.en.pdf?88c21ee4d8283b0cbd89a25700b32cda)> accessed 10 September 2017.

<sup>459</sup> Prudential Regulation Authority, *Strengthening Capital Standards: Implementing CRD IV* (Bank of England, Consultation Paper, CP5/13, August 2013) <<http://www.bankofengland.co.uk/pru/Documents/publications/cp/2013/cp513.pdf>> accessed 10 September 2017.

by banks in being required to keep higher capital ratios<sup>460</sup>; the effects on the industry as bank financing becomes less available (in light of higher capital ratio constraints); the incentives to transfer financing activities from regulated entities to unregulated entities (such as shadow banks), and what the implications are of having financing activities being provided by non-banks (particularly for industries which require long-term financing). Furthermore, economic analysis should also identify the potential for regulatory arbitrage which exists as a result of the self-interested approach which states and the industry adopt.

### ***4.3 Legitimacy and Accountability of the Basel Accords***

Both “*legitimacy*” and “*accountability*” are essential for laws and regulations to be upheld by their subjects. It has thus been stated that “*the interplay of legitimacy and authority determines who obeys global norms*”<sup>461</sup>. As will be seen below, it has been argued that transnational regulatory laws generally suffer from both a lack of legitimacy as well as a lack of accountability in the absence of a proper economic analysis being adopted, and this Section will therefore examine the extent to which this lack of legitimacy and accountability may hinder the Basel Accords from reaching their stated objectives.

Transnational regulatory networks such as the BCBS do not only have to be “*legitimate*” in the eyes of the industry being affected by the Basel Accords and accountable to them, but they also need to be “*legitimate*” and “*accountable*” towards states and national regulators too, given that transnational regulatory networks are dependent upon the latter in order to give effect to the transnational regulatory laws they promulgate. This thesis argues that the Basel Accords suffer from there being a lack of legitimacy of the BCBS in the eyes of states (acting individually) and of the industry, with this resulting in serious constraints which hinder the Basel Accords from reaching their stated aims.

Section 2.3 of this thesis has argued that the Basel Accords have been applied without there being a proper analysis of who the main players are and what the main interests of these different actors are. Whilst different nation states come together (together with the BCBS) in order to establish transnational regulatory laws, individual nation states and the industry are then tasked with adopting, enforcing and abiding by the said transnational regulatory laws, notwithstanding that states acting out of self-interest may consider the Basel Accords to be an unnecessary burden which they need to be seen as being compliant with. Given that the international community has no binding power,

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<sup>460</sup> Tarullo (n 21) 209.

<sup>461</sup> Halliday (n 12) 285.

and relies solely on soft-law and peer pressure, the proper adoption and adherence to such transnational regulatory laws can only be achieved if each of the main actors consider the Basel Accords to have been adopted through a legitimate body and if they consider that there is an element of accountability on adhering to those transnational regulatory laws.

The legitimacy and accountability of the Basel Accords is here analysed by relying on traditional literature (which is reviewed in Section 4.3.1) which deals with the legitimacy and accountability of national regulatory agencies, and extending these principles further to transnational regulatory networks. Furthermore the principles which are usually adopted in relation to the legitimacy and accountability of national regulatory agencies need to also be extended further in order to consider the legitimacy and accountability of transnational regulatory bodies in the eyes of states and their national regulatory agencies.

#### **4.3.1 Defining “legitimacy” and “accountability”**

Black has defined “*legitimacy*” as follows: “[l]egitimacy, in its regulatory context, is an acceptance that a person or organisation has a right to govern both by those it seeks to govern and those on whose behalf it purports to govern”, and continues by stating that notwithstanding various strategies which may be adopted in order for a regulatory agency to seek to gain legitimacy, this will very much depend on the extent to which this claim to legitimacy is “*accepted by others*”<sup>462</sup>. Shaffer has similarly stated that “*legitimacy*” refers to “*the subjective belief of actors that a rule or institution should be obeyed*”, and that “*it depends on whether actors regard the institutions and processes that promulgate and convey it as “rightful”, and thus authoritative*”<sup>463</sup>.

Though Habermas has been of the view that only “*political orders can have and lose legitimacy*”, and that “[m]ultinational corporations or the world market are not capable of legitimation” (as he assumes that “*political orders*” are tantamount to “[s]tates”)<sup>464</sup>, it is here argued that regulatory agencies, even when operating on a transnational level do constitute a relatively new type of political order whereby transnational rule-making bodies come together in order to propose and promulgate transnational laws and transnational regulatory laws to be imposed on their separate subjects.

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<sup>462</sup> Black and Rouch (n 49) 225.

<sup>463</sup> Shaffer (n 201) 249.

<sup>464</sup> Jürgen Habermas, ‘Legitimation Problems in the Modern State’ in Jürgen Habermas (ed), *Communication and the Evolution of Society* (Beacon Press, Boston, 1979) 179.

The “legitimacy” of global governance institutions has also been described as follows<sup>465</sup>:

*‘Legitimacy’ has both a normative and a sociological meaning. To say that an institution is legitimate in the normative sense is to assert that it has the right to rule – where ruling includes promulgating rules and attempting to secure compliance with them by attaching costs to noncompliance and/ or benefits to compliance. An institution is legitimate in the sociological sense when it is widely believed to have the right to rule.*

On referring to “legitimacy” in relation to “states”, Habermas has considered how “legitimacy” is measured “against the belief in its legitimacy on the part of those subject to the domination”<sup>466</sup>. He therefore continues by stating that this becomes a question of “belief that the structures, procedures, actions, decisions, policies, officials, or political leaders of a state possess the quality of rightness, of appropriateness, of the morally good, and ought to be recognized in virtue of this quality”<sup>467</sup>.

The term “accountability”, on the other hand, refers to the “means by which legitimacy can be assessed”<sup>468</sup>.

Avgouleas argues that transnational regulatory networks such as the BCBS face more questions about “accountability” rather than with regard to “legitimacy”, particularly in light of the fact that “soft-laws” established by these bodies are not complemented by structures of accountability<sup>469</sup>. Verdier also argues that transnational regulatory networks are bound to be primarily accountable towards demands of their “domestic constituencies”, rather than to “the goal of international cooperation for its own sake”<sup>470</sup>. Thus, he states that national regulatory agencies acting at a transnational level, continue to be accountable to each of the legislative, executive and judicial branches of their states, as well as to the public at large and media of that same state<sup>471</sup>. They also continue to be subject to administrative law requirements and legal constraints arising out of national laws<sup>472</sup>.

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<sup>465</sup> Avgouleas (n 11) 361.

<sup>466</sup> Habermas (n 464) 199.

<sup>467</sup> *ibid.*

<sup>468</sup> Black and Rouch (n 49) 225.

<sup>469</sup> Avgouleas (n 11) 361.

<sup>470</sup> Verdier 2009 (n 10) 121.

<sup>471</sup> *ibid* 126.

<sup>472</sup> *ibid* 126 – 128.



Black, in advancing her deliberative democratic approach to law and its requirement for legitimacy, has stated<sup>473</sup>:

*... Law and the exercise of political power is legitimate to the extent that it has been agreed upon by citizens in a process of deliberative opinion and will formation, a process that itself has to conform to certain conditions which will allow undistorted communication. There is thus an internal relation between law and democracy, not simply an historical association. The legitimacy of law depends on undistorted public communication, but as noted law has in turn to secure the infrastructure that will allow that communication to occur in accordance with those conditions. There is moreover an internal relation between law and political power. In part this lies in their mutual interdependence. Law needs political power in the form of an organized state to be able to perform the function of stabilizing expectations between citizens. Political power needs law in order to be able to issue binding norms and to implement collective goals, and indeed to provide the basis for its organizations and procedures. It is not a case of a simple exchange between the two, however. For law to operate it also has to serve as a resource of justice, it has to be legitimate. This will be lost if it is used by political power for just any purpose: the familiar antagonism between law and politics.*

Black therefore considers proceduralization as being necessary for legitimation of law, and has considered how regulators should act as mediators and translators between different parties, and be capable of mapping differences and conflicts between deliberants, with a view of a solution being reached through effective regulation<sup>474</sup>. Black therefore mainly focuses on how interpretative communities can be fostered, on regulation being a means of conversation, and on the limits and possibilities of law itself<sup>475</sup>.

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<sup>473</sup> Julia Black, *Proceduralizing Regulation: Part I* (Oxford Journal of Legal Studies, Vol. 20, No. 4, 2000) 611.

<sup>474</sup> This has been the subject of debate amongst authors such as Teubner and Habermas: in the “thin” conception as proposed by Teubner legitimation would take place through bargaining, voting and compromising; whilst in the “thick” conception proposed by Habermas, mutuality and consensus are required, together with the inter-subjective understanding of deliberative democracy, making use also of the discourse principle which would involve duties of reciprocity, civility and the use of public reason; Black (n 473) 598 – 599; Black (n 134). See also: Julia Black, *Rules and Regulators* (Clarendon Press, 1997) 37 – 44.

<sup>475</sup> Michael Moran, *Review Article: Understanding the Regulatory State* (British Journal of Political Science, Vol. 32, Issue 2, April 2002) 400 – 401 <[http://journals.cambridge.org/abstract\\_S0007123402000169](http://journals.cambridge.org/abstract_S0007123402000169)> accessed 10 January 2015.

Though the above has been stated by Black in her contribution to “*regulation*” generally, it is here argued that the same issues still apply, and may become even more marked when considering the implementation of transnational regulatory standards. It has been argued that networks such as the BCBS lack the necessary systems for the exercise of a deliberative democratic approach<sup>476</sup>. Whilst typically business regulation emanates from an “*array of private sector, civil society, multi-stakeholder and hybrid public-private institutions operating in a dynamic, transnational regulatory space*”, and not just from “*conventional state and inter-state institutions*”, it is here argued that the Basel Accords only consider the interests of national regulators coming together in one international community, and the lack of consideration of interests of other actors gives rise to problems and challenges which hinder the effectiveness of the Basel Accords, rather than help in its development<sup>477</sup>.

On referring to the “*globalization paradox*” Slaughter does not consider transnational regulatory networks as giving rise to issues of democratization and accountability, seemingly by relying on the fact that the members of these networks (i.e. the national regulatory agencies) have their own democratic and accountability credentials (without going into the debate as to whether these are sufficient or otherwise)<sup>478</sup>. She therefore defends the democratic and accountability credentials of transnational regulatory networks by comparing these transnational regulatory networks to systems of global regulation which would by their nature be “*amorphous*” and “*unaccountable*”<sup>479</sup>. Nevertheless, it is here argued that having an unaccountable transnational regulatory network only means that the actors whose interests are not aligned to that of the transnational regulatory network will seek to find ways and means around the transnational regulatory law (through regulatory arbitrage), particularly where the said actors consider there to be a lack of legitimacy of the said network.

In order for regulation to be successful, particularly when emanating from transnational law and transnational regulatory networks, the entities to whom such laws and regulations apply need to recognise those laws and regulations as being legitimate laws and regulations. If one were to look at society and law-making, one would least have

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<sup>476</sup> Trachtman (n 85) 35.

<sup>477</sup> Burkard Eberlein and others, *Transnational Business Governance Interactions: Conceptualization and Framework for Analysis* (Regulation & Governance, Volume 8, Issue 1, 2014) 1 <<http://onlinelibrary.wiley.com/doi/10.1111/rego.12030/abstract>> accessed 10 January 2015.

<sup>478</sup> Verdier 2009 (n 10) 119 – 120.

<sup>479</sup> *ibid* 120.

issues with “*legitimacy*” when such laws would have been promulgated directly through Parliament – where the people’s representatives, elected through a democratic process, legislate in order to establish orderly systems through which members of the society can interact. This process is however much more fragmented, however, when dealing with national regulatory agencies and transnational regulatory networks.

The systems at play in transnational regulatory networks are somewhat hierarchical, with transnational regulatory networks establishing regulations which need to be implemented by national regulators, and applied to the industry. Therefore legitimacy of transnational regulatory networks goes one step further than legitimacy of national regulatory agencies since the transnational regulatory networks also need to be legitimate and acceptable to both states as well as to the industry, with regulatory conversations being essential at all levels.

#### **4.3.2 Legitimacy of National Regulatory Agencies**

The topic of “*legitimacy*”, was subject to various discussions and divergent views upon the establishment of national regulatory agencies, as these regulators typically have rule-making functions, an executive branch in order to give effect to the rules they promulgate, as well as a dispute-resolution mechanisms (such as a Tribunal) where matters relating to regulation can be resolved. Regulatory agencies have therefore been criticised as possibly leading to a lack of “*transparency, accountability, due process and participation, as well as several values typically associated with formal conceptions of the rule of law*”<sup>480</sup>.

The traditional argument in favour of legitimacy which national regulatory agencies put forward is that national regulatory agencies are established by statute and obtain their legitimacy from the fact that the persons appointed to lead these regulatory agencies, would have been appointed by the persons who would have been elected democratically, with these regulatory agencies then being accountable towards Parliament. Thus legitimacy is generally considered to be satisfied if the executive and the legislature of a state retain the power to establish the priorities of regulatory agencies, appoint and remove the persons who manage these agencies and if the state is briefed and consulted by these regulatory agencies<sup>481</sup>.

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<sup>480</sup> See: Karen Yeung, *Better Regulation, Administrative Sanctions and Constitutional Values* (Legal Studies, Vol. 33, No. 2, June 2013).

<sup>481</sup> Pan (n 110) 811.

States are therefore said to have struck a “*governance bargain*” with regulatory organisations by granting them the authority to regulate specific industries (with the same argument also applicable to self-regulating organisations, in instances where the Government would have granted this authority by failing to impose specific laws or regulations itself), by allowing them to regulate conduct over areas of social and economic life, on the specific understanding that regulatory powers will be withdrawn should they fail to deliver to the satisfaction of the state<sup>482</sup>.

Black argues that the process of legitimation, however, also requires administrative arms of a state to make use of “*communicative power*”, and that a regulatory agency therefore “*cannot derive its legitimacy from the connection between the political institutions and communicative power*”<sup>483</sup>. Rather, regulatory agencies need to make direct use of communicative power, by entering into deliberative proceduralism as part of the process of such regulatory agencies’ claim to legitimacy and accountability<sup>484</sup>. The methods regulatory agencies adopt (or should adopt) in order to enhance their legitimacy and accountability have been discussed in detail by Black, though a detailed analysis of this is beyond the scope of this thesis<sup>485</sup>.

#### **4.3.3 Legitimacy of Transnational Regulatory Bodies**

Regulation emanating from transnational regulatory bodies goes one step further than rules which emanate from national regulatory agencies. Transnational regulatory bodies are typically made up of representatives from regulatory agencies from different states with there not necessarily being any constitutional mechanism of accountability as would typically be found in liberal democratic constitutional systems<sup>486</sup>.

The democratic credentials of transnational regulatory bodies are limited to the extent that “*their members are representatives of governments which are regarded as legitimate within their own nation states*”<sup>487</sup>. They have therefore been criticised as not having any form of legitimacy or accountability<sup>488</sup>. Furthermore, concerns have also been raised in that domestic regulatory agencies may use transnational regulatory networks to seek to

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<sup>482</sup> Black and Rouch (n 49) 224.

<sup>483</sup> Black (n 473) 613.

<sup>484</sup> *ibid* 614.

<sup>485</sup> Julia Black, *Calling Regulators to Account: Challenges, Capacities and Prospects* (LSE Law, Society and Economy Working Papers 15/2012) <[http://www.lse.ac.uk/collections/law/wps/WPS2012-15\\_Black.pdf](http://www.lse.ac.uk/collections/law/wps/WPS2012-15_Black.pdf)> accessed 10 January 2015.

<sup>486</sup> Black and Rouch (n 49) 224.

<sup>487</sup> *ibid* 227.

<sup>488</sup> Barr and Miller (n 112) 15.

free themselves from “*domestic constraints*” in order to pursue “*self-regarding aims*”<sup>489</sup>. Shaffer has also noted how “*national actors are more likely to perceive transnational law to be legitimate where the law is formulated by actors who share their interests, where the process is procedurally fair and characterized by noncoercive reasoned argument, and where the results are functionally efficacious*”<sup>490</sup>. He however notes how transnational legal orders exercise their power through coercion, reciprocity, persuasion and acculturation, but they can be effective only if they are perceived to be legitimate by the different actors<sup>491</sup>.

The Basel Accords have been promulgated following negotiations by representatives from G10 members (and subsequently extended to the G20 members), with these standards then being implemented in most jurisdictions across the globe<sup>492</sup>. The trail towards a legitimate claim is therefore more remote here than in national regulatory agencies particularly since the varying negotiating positions of different states needed to be amended and discarded as the representatives of each state put forward their views and negotiated what the international standards should consist of. It has been clearly documented that, by way of example, in the US there were also divergent views adopted by different US regulatory agencies at the Basel negotiating table, meaning that there was not even one common position which represented the views of the US (though some authors have used this in order to argue that this “*internal*” disagreement between US’ regulatory agencies helped increase transparency of the Basel process)<sup>493</sup>. It has thus been stated that the “*Basel Committee is perhaps the most important example of a transgovernmental regulatory network that exercises vast powers, seemingly without any form of democratic accountability*”<sup>494</sup>.

Furthermore, the representatives of states in the BCBS are generally representatives from central banks, who also have their legitimacy queried at a national level particularly in light of the fact that central bankers are many times insulated from any type of political accountability, with this position usually being resorted to in order to

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<sup>489</sup> Verdier 2009 (n 10) 119.

<sup>490</sup> Shaffer (n 201) 249.

<sup>491</sup> *ibid* 249 – 251.

<sup>492</sup> Jasper Blom, ‘Banking’ in Daniel Mügge (ed), *Europe and the Governance of Global Finance* (Oxford University Press, 2014) 47.

<sup>493</sup> Barr and Miller (n 112) 32 – 33.

<sup>494</sup> *ibid* 17.

ensure the independence of central banks from political influences particularly in carrying out their required monetary policy functions<sup>495</sup>.

This perceived lack of legitimacy is also in stark contrast to private international law (or “*conflict of laws*”) which has been promulgated by states from time to time and which was the main method of cross-border cooperation before the rise of transnational law and transnational regulation. Private international law was seen as a way through which international interests could be advanced, with this system being deeply rooted in national laws and domestic sovereignty – thus limiting any claims to such a system’s legitimacy<sup>496</sup>. As a result of this, international regulatory cooperation focused on areas of law which “*could be defended on the ground*”, and which were thus considered to be in the best interests of the jurisdiction implementing those laws<sup>497</sup>. This meant that the main focus of laws was uncontroversial in nature, and consisted of matters such as the proliferation of international commerce, international cooperation, and comity of nations<sup>498</sup>.

On the other hand it has been argued by Wai that as transnational business networks work closer with each other, a sense of shared common interests and norms may be fostered, such that parties may lose their appeal towards looking at national regulation, whilst adopting a preference to make use of transnational regulatory law, and with this also leading to national laws losing their legitimacy and relevance over time<sup>499</sup>. One must however here point out that any such argument can only be made in relation to certain types of transnational laws and regulation which are promulgated by the industry or with help from the industry (as is the case with transnational laws referring to arbitration and alternative dispute-resolution mechanisms, being the main subject-matter referred to by Wai). It is here submitted that financial regulation such as the Basel Accords (and which has been promulgated through a top-down approach without any significant involvement from the industry) will not benefit from legitimacy in the same way.

#### **4.3.4 A ‘Global Administrative Law’**

In light of the claims of lack of legitimacy and accountability, transnational regulatory bodies seek to build a claim towards legitimacy and accountability in a number of ways,

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<sup>495</sup> *ibid* 18 – 19.

<sup>496</sup> Wai (n 45) 239, 242 – 243.

<sup>497</sup> *ibid* 244.

<sup>498</sup> *ibid*.

<sup>499</sup> *ibid* 258 – 259.

particularly by working together with national regulatory agencies which can help in enforcing transnational regulatory rules which they would have established, entering into public consultation exercises and acting in a transparent manner particularly with regard to their decision-making structures<sup>500</sup>.

The contention is that a “*global administrative law*” should govern the main proponents of transnational laws, essentially being the transnational bodies and states, with the underlying principles being similar to domestic administrative law principles, such as “*accountability, fairness, protection of individual rights, and some sense of democratic decision-making*”<sup>501</sup>.

This is particularly useful if domestic democratic credentials are lacking as well as if there is a high risk of regulatory capture, and the international standards adopted through a “*global administrative law*” can help to rectify claims of lack of legitimacy<sup>502</sup>. It has been argued that the emergence of a “*global administrative law*” occurs through the “*intersection and interaction among domestic and international administrative processes*”, which takes place through systems which seek to improve the transparency of these systems, and includes the use of “*notice and comment rule-making*”, increasing public participation, and entering into proper cost-benefit analysis and rationality review<sup>503</sup>. These methods can take place at both the national as well as at the transnational level, with democratic credentials being particularly a function of domestic administrative law, whilst on the other hand also having a “*global administrative law*” that can help in providing more transparency and in providing oversight over the national law systems of administrative law<sup>504</sup>.

Verdier has however highlighted contradictions in the “*global administrative law*” argument, by highlighting that whereas proponents of a “*global administrative law*” have considered national divergences to regulations implementing transnational regulatory laws to be desirable, in that they enhance the legitimacy of these regulations, the main rationale for these same regulations would have been that of establishing further regulatory cooperation and regulatory consistency<sup>505</sup>. He consequently argues that national variation may actually be the result of an ineffective regime which does not

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<sup>500</sup> Black and Rouch (n 49) 227 – 228.

<sup>501</sup> Barr and Miller (n 112) 16.

<sup>502</sup> *ibid* 43.

<sup>503</sup> *ibid* 45; Avgouleas (n 11) 362; Verdier 2009 (n 10) 140 – 141.

<sup>504</sup> Barr and Miller (n 112) 45 – 46; See also: Verdier 2009 (n 10) 169.

<sup>505</sup> Verdier 2009 (n 10) 169 – 170.

reach the stated goals of the transnational regulatory laws which would have been established<sup>506</sup>. Verdier therefore argues that there is a paradox here, whereby<sup>507</sup>:

*On the one hand, if networks are effectively held accountable through domestic legal and political constraints, then their contribution to global governance will be limited. On the other hand, the more domestic autonomy they have, the more likely they are to enhance international enforcement and harmonization of standards – but also to act in ways that reflect the self-interest of regulators rather than aggregate welfare.*

In light of the claims which the BCBS has faced in that it lacks elements of a constitutional criteria (as part of its legitimacy requirements), it has sought to enhance its accountability and legitimacy by engaging in a consultative process prior to the promulgation of the Basel II Accords (which was a marked difference from the promulgation of Basel I, which was agreed to through closed meetings without any transparency), thus seeking to improve its transparency<sup>508</sup>. Furthermore, the national regulatory agencies forming part of this process have also sought to enhance the legitimacy of the process by subjecting the Basel standards to national consultation procedures, thus complementing the efforts towards enhancing legitimacy promoted by the BCBS<sup>509</sup>.

However, it is here argued that states act rationally and out of self-interest in seeking to implement the Basel Accords selectively in order to gain advantages over other states. Whilst states need to necessarily be seen as forming part of an international community which establishes global standards to increase regulatory convergence and reduce the possibilities of systemic risks, individual states also act out of self-interest in seeking to have more beneficial laws (or less restrictive laws) than those of other states (and notwithstanding that the main reason for the Basel Accords was to have regulatory convergence), thereby reducing the claim to legitimacy of the Basel Accords.

#### **4.3.5 Lack of Legitimacy and Accountability of the Basel Accords**

Despite the objective of harmonisation of the Basel Accords, these international standards are still subject to varying methods of implementation within national laws and regulation, such that the standards adopted at a national level are typically very

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<sup>506</sup> *ibid.*

<sup>507</sup> *ibid* 170.

<sup>508</sup> Barr and Miller (n 112) 17, 24 – 27.

<sup>509</sup> *ibid* 17, 28 – 39, 44.



different from the original texts which would have been agreed to at a transnational level. It has been noted how international standards such as the Basel Accords are primarily adopted by states as a result of the “*peer pressure*” applied by other states and by market forces (including through credit rating agencies)<sup>510</sup>. Furthermore, the perceived lack of legitimacy by states and local actors towards the international community gives rise to resistance towards the proper adoption of such a transnational regulatory law<sup>511</sup>. Halliday and Shaffer have also noted that “*if transnational legal norms are perceived to be instruments of imposition, coercion, surveillance, or control by stronger actors on weaker states or local actors, then the probability of resistance increases*”<sup>512</sup>.

The problem of lack of legitimacy also arises since transnational regulatory bodies tend to “*gravitate far too quickly*” towards rulemaking, instead of seeking to work towards harmonizing established regulatory practices<sup>513</sup>. Therefore whilst transnational regulatory bodies have been somewhat efficient in proposing rules, their role in supervising and enforcing the rules they would have established has been very limited given that they typically rely on domestic regulators which may have their own interpretations (together with their own preferences and limitations) and which may therefore lead to significant variances in the ways in which transnational regulatory laws are adopted across borders<sup>514</sup>. Avgouleas has therefore stated that though the success of “*soft laws*” is highly dependent upon there being a system of identifying “*defections and deviations from what has been agreed*”, the methods of monitoring and enforcement of such laws have been quite weak<sup>515</sup>.

Claims of lack of accountability and of lack of legitimacy in relation to the Basel Accords also arise as states which did not form part of the “*negotiating table*” are faced with no option (due to the market pressures referred to above) other than to implement the international standards which would have been negotiated and agreed to by national regulators of other jurisdictions<sup>516</sup>. The BCBS has therefore been criticised for not paying sufficient attention to the needs of the BRIC countries (which only started to form part of the BCBS as from 2010) and to those of emerging economies, with these jurisdictions facing pressures from bodies such as the IMF and the World Bank to adopt

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<sup>510</sup> Black and Rouch (n 49) 219, 224; Brummer (n 100) 284 – 288.

<sup>511</sup> Halliday and Shaffer (n 12) 500.

<sup>512</sup> *ibid.*

<sup>513</sup> Riles (n 46) 82.

<sup>514</sup> *ibid.*; Verdier 2009 (n 10) 114 – 116.

<sup>515</sup> Avgouleas (n 11) 359.

<sup>516</sup> Barr and Miller (n 112) 20, 44; Hyoung-kyu Chey (n 122) 53 – 67.

these standards<sup>517</sup>. Therefore whilst certain positions may have been agreed to transnationally, they might have been agreed to with views pertaining to certain types of countries (such as North Atlantic jurisdictions), with these rules not necessarily being adequate for developing and emerging economies<sup>518</sup>. It has also been argued that the standards setting out the capital requirements are biased towards developed-market economies, as against developing countries, and that the latter face higher costs of capital than the former in reaching the same capital requirements<sup>519</sup>. This reduces the Basel Accord's legitimacy claims in those countries which were not represented on establishing these international standards. In what can be seen as an attempt by the BCBS to increase its legitimacy, it has expanded its membership to include G20 members as from 2010 (and prior to that only used to be composed of the G10 members)<sup>520</sup>. This expansion has however also been criticised in that it does not ensure that all relevant players are present in the BCBS (e.g. Argentina which only has a negligible presence in financial markets forms part of the G20, whilst Singapore does not)<sup>521</sup>.

Another element which reduces the legitimacy of these international standards is that typically transnational regulatory networks only look at regulation falling within their particular area of focus – by way of example, though the main impact of capital requirements will be towards the banking industry (and the financial industry), this will also affect counterparties to such entities as well as consumers<sup>522</sup>. It can however hardly be said that counterparties and consumers also had a say when the Basel Accords were being promulgated by the BCBS<sup>523</sup>. Furthermore, transnational regulatory networks such as the BCBS hesitate to look beyond their particular areas of focus (possibly also in order to avoid stepping into regulatory realms of other transnational regulatory networks such as IOSCO). This may also be a reason as to why the Basel Accords have been (and continue to be) limited to “*internationally-active banks*”, and not to investment firms and to alternative financing instruments. One should here also note that the BCBS is composed of members from Central Banks, which typically only regulate banks.

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<sup>517</sup> Black and Rouch (n 49) 227; Barr and Miller (n 112) 17, 20, 40; Brummer (n 100) 289.

<sup>518</sup> See also: Riles (n 46) 75 – 76; Avgouleas (n 11) 362.

<sup>519</sup> Johann Jacobs and Gary van Vuuren, *Is Regulatory Capital a Legitimate, Comparable and Objective Global Standard? Evidence From 51 Institutions Across 17 Countries* (South African Journal of Economic & Management Sciences, Vol. 17, Issue 3, 2014) 277.

<sup>520</sup> Quaglia (n 57) 435; Black (n 75) 8; Blom (n 492) 47.

<sup>521</sup> Black (n 75) 20 – 21.

<sup>522</sup> Black and Rouch (n 49) 224, 226 – 227.

<sup>523</sup> *ibid* 224.

The fact that transnational regulatory bodies operate transnationally means that it is uncertain as to whom these bodies are accountable to, and on whose behalf they act<sup>524</sup>. Given that there is no clarity as to who may call these bodies to account (and whether there is even the possibility of there being judicial review of the activities carried out by them), and given that there is no structure for these transnational regulatory bodies to be accountable, gives rise to further legitimacy issues<sup>525</sup>. This is exacerbated by the fact that implementation by national regulatory agencies of the transnational standards may be segmented between different national regulatory agencies and by national and local Courts, such that the industry cannot hold one national regulator accountable for the improper adoption of the international standards, particularly when different interpretations are adopted at a national level<sup>526</sup>.

It has also been noted how a lack of legitimacy may arise due to a lack of constitutional criteria in the BCBS given the lack of enforcement and dispute-resolution processes<sup>527</sup>. This has made it difficult for the BCBS to counteract domestic pressures, particularly on implementation of the Basel Accords<sup>528</sup>. The BCBS's response to this has been through the establishment of peer-review systems such as the Regulatory Consistency Assessment Programme established by the BCBS and also through the use of peer-review systems undertaken by other bodies such as through the Financial Sector Assessment Program established by the IMF<sup>529</sup>. Black has however been skeptical of peer-review systems since she states that as states know that they all have their own weaknesses, they will be reluctant to criticise each other<sup>530</sup>.

The fact that the objectives of the Basel Accords have changed along the years (according to the self-interest of major states) also questions the legitimacy of the Basel Accords. As seen in Chapter 3, the initial objective of having regulatory convergence between states became less and less important over time (particularly as Japanese banks lost the competitive edge they had prior to the introduction of the Basel Accords, and amidst

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<sup>524</sup> *ibid.*

<sup>525</sup> *ibid.*

<sup>526</sup> *ibid* 224 – 225.

<sup>527</sup> *ibid* 227.

<sup>528</sup> Verdier 2009 (n 10) 143.

<sup>529</sup> See also: Avgouleas (n 11) 342; Trachtman (n 85) 36; Julia Black, 'Prudential Regulation of Banks' in OECD, *International Regulatory Co-operation: Case Studies, Vol. 2: Canada-US Co-operation, EU Energy Regulation, Risk Assessment and Banking Supervision* (OECD Publishing, 2013) 70, 78 – 79; Basel Committee on Banking Supervision, *Twelfth Progress Report on Adoption of the Basel Regulatory Framework* (Bank for International Settlements, April 2017) 1 <<http://www.bis.org/bcbs/publ/d404.pdf>> accessed 26 April 2017.

<sup>530</sup> Black (n 75) 25.

pressure from major western banks for a more lenient regime) in favour of a shift towards regulating in order to prevent “systemic risks”<sup>531</sup>. Furthermore, one can also argue that neither of these objectives have been reached (particularly following the recent global financial crisis), thereby hurting the functional legitimacy of the Basel Accords.

The unraveling and re-negotiation of the Basel Accords on implementation (or lack of implementation) at a regional or national level can also hardly help their claim towards legitimacy<sup>532</sup>. It has been recognised that regulators who participate in international fora such as the BCBS often return to a “*great deal of skepticism from domestic politicians and even other domestic regulators who have not been part of the international negotiation process*”<sup>533</sup>. Though some authors have argued that having national variances in themselves enhance the legitimacy of the Basel Accords, as different states enter into a “*fluid process of convergence, rather than a dogmatic insistence that harmonization requires that all nations’ laws be the same*”, this claim does need to be challenged<sup>534</sup>. The argument of these authors would have held water should states seek to supplement (rather than amend) the international Accords, or should they have decided to get things done differently in order to ensure compliance with national laws. However, the fact that the changes made at national level have led to possibilities of regulatory arbitrage, whilst nullifying (or weakening) the effects of the Basel Accords, leads on to question the legitimacy of these international standards.

Furthermore, the fact that the Basel Accords had to be revamped a number of times (with Basel III being introduced when Basel II was even yet to be fully implemented, particularly in the US<sup>535</sup>), and with long transitory periods for these Accords to take effect in different states (leading to the argument that most probably these Accords may become outdated before even being fully implemented, as industry players evolve, also in anticipation of what the laws and regulations would be looking like in the coming years as the Accords are implemented fully), can hardly help its claim towards these international standards being considered as “*legitimate*”.

Regulation is, of its nature, bound to always be one step behind the market, thus being oriented to fixing the problems of the last crisis or problem, without being able to

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<sup>531</sup> See also: Verdier 2009 (n 10) 137 – 139, 143.

<sup>532</sup> Riles (n 46) 77; Blom (n 492) 51; Ferran (n 188) 20.

<sup>533</sup> Riles (n 46) 78.

<sup>534</sup> Barr and Miller (n 112) 32.

<sup>535</sup> Riles (n 46) 78.

understand or seek to deal with problems which may be ensuing from new systems adopted by the market<sup>536</sup>. This argument can also be applied to transnational regulatory laws in the same way as it has been used with regard to regulation generally, and particularly in the case of the Basel Accords in light of the length of time until new standards which would have been agreed to are implemented (meaning that this gives arbitrageurs the opportunity to work around the revamped international standards). Black has also argued that the crisis has shown that regulators have failed, due to the fact that they did not understand the markets, and that the ways in which markets and regulation interacted were flawed<sup>537</sup>. Black therefore states that “*regulators did not have adequate information nor did they have a means of making sense of what they had*”<sup>538</sup>.

The fact that the Basel Accords can only be changed or amended with transnational agreement also hurts the legitimacy of these Accords, whilst also providing a breeding space for further regulatory arbitrage as industry players understand the intricacies of how the said international standards would have been applied in different jurisdictions<sup>539</sup>. This makes the Accords unresponsive to changes in the industry (notwithstanding the fact that the use of “*soft laws*” has been advocated in light that they should provide a flexible regulatory regime)<sup>540</sup>. Black has therefore criticised the move towards further hierarchical regulation following the financial crisis, since this type of regulation introduces rigidities into the system, hindering flexibility and scope for variety as the need for this arises, as markets evolve<sup>541</sup>. Regulators need flexibility in light of changes which take place to regulated entities from time to time (such as changes to their scope, attitudes, and their available knowledge, expertise and resources), with this also being essential in order to allow regulators to plug gaps which arise as a result of regulatory arbitrage<sup>542</sup>.

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<sup>536</sup> *ibid* 82 – 83.

<sup>537</sup> Black (n 75) 4, 11 – 12.

<sup>538</sup> *ibid* 16; See also: Black (n 180) 1058.

<sup>539</sup> Katharina Pistor, *A Legal Theory of Finance* (Journal of Comparative Economics, Vol. 41, 2013) 328.

<sup>540</sup> *ibid*.

<sup>541</sup> Black (n 75) 4.

<sup>542</sup> *ibid* 6 – 7.

#### 4.3.6 “Regulatory Conversations” as a Means to Enhance the Legitimacy of the Basel Accords

The consultative processes entered into by the BCBS on adopting Basel III may be seen as an attempt to seek to enter into “regulatory conversations”<sup>543</sup> with the relevant participants in the market in order to give legitimacy to these international standards. Nevertheless it is here argued that the establishment of public consultation possibilities is not sufficient for legitimacy claims to be satisfied, in light of the various claims of lack of legitimacy discussed in this thesis. Furthermore, in light of the quest for regulatory harmonisation across borders, and in light of the use of “soft-laws” across borders, the importance of having regulatory conversations here is much more marked – particularly when considering the self-interest of the different actors, and the need for acceptability of these international standards by all actors in order to have a successful transnational regulatory law.

In considering how international rule-making should develop in light of the financial crisis, and on considering the need of involvement of the various players who deal with international standards, Black considered that<sup>544</sup>:

*...it is possible to foresee the emergence of something approaching a “legal and regulatory wikipedia”, operating at multiple levels in which the participants are the market, advisors, industry associations and regulators, but with the public sector acting as an arbiter of acceptability in relation to macro-level standards and an umpire in relation to their practical implementation. In that sort of environment, consensus tends to replace dominance in establishing standards....*

It may be argued that the attainment of consensus between national regulatory agencies in promulgation of the Basel Accords, weighs in its favour in having established international standards to which all members of the BCBS would have agreed to. However, though “consensus” would be ideal and possibly preferred by all parties, one needs to consider the deeper question of whether the consensus reached can also be seen as a consensus also amongst all relevant actors (i.e. including states and the industry) and whether the approach adopted by the BCBS consists of a sufficient deliberative approach.

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<sup>543</sup> The term “regulatory conversations” as used here partakes from Black’s use of this terminology when discussing “regulation”. See: Julia Black, *Regulatory Conversations* (Journal of Law and Society, Volume 29, Number 1, March 2002).

<sup>544</sup> Black and Rouch (n 49) 223.

In this sense, therefore, Cranston has stated<sup>545</sup>:

*If a commercial instrument is to meet its professed aim, then those most affected by its operation need to be part of the process of formulating it. What is necessary is that the process must be transparent and must accord all interests an opportunity to have an influence. With international commercial lawmaking, the input of developing countries is especially important, not least if an instrument is to have legitimacy and be widely adopted.*

Furthermore, though the members of the BCBS agreed to specific texts, this only came after various long-winded negotiations with the addition of very detailed rules in order to please different parties (and with states still knowing that the agreed texts only consisted of soft-law). Furthermore, changes have been introduced by national regulatory agencies in the implementing national laws and regulations which seek to implement the Basel Accords, with claims also being made of there being a whole re-negotiation of the Basel Accords in the EU (in the run-up to the promulgation of the CRD IV and the CRR).

“Regulatory conversations” are, furthermore, essential in the promulgation of transnational regulatory laws in light of these instruments being “regulatory” in nature. This means that they are bound to be viewed negatively by the industry as they invariably lead to changes in established processes and add costs to the industry, as industry participants are faced with additional regulatory burdens. The receptability, and hence acceptability of these regulations by the industry is necessarily dependent upon the perceived benefit the industry considers these measures have over their activities. The requirements on minimum capital ratios have however been considered as nothing more than a “tax” which the industry needs to absorb<sup>546</sup>. This leads towards market players seeking to arbitrage out of these requirements in the same way as a tax would be treated<sup>547</sup>. On the other hand should there be a perceived benefit of these regulations, the industry would embrace the imposition of these regulations. Goode has thus argued that “*in the field of commercial law it is vitally important to involve*

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<sup>545</sup> Cranston (n 47) 607.

<sup>546</sup> David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues* (Journal of Banking & Finance, Vol. 24, 2000) 38.

<sup>547</sup> *ibid.*

*organisations representing the relevant business sectors from the outset and to do so not merely by way of consultation but through an active contribution to the scientific work*"<sup>548</sup>.

"Regulatory conversations" and "regulatory arbitrage" can be considered to be mutually exclusive, with these two options regulating the relationship between the regulators and industry participants. A lack of regulatory conversations will invariably lead to a mutual lack of understanding of objectives and methodologies by the regulators and the industry, resulting in the industry looking further towards regulatory arbitrage. On the other hand, should proper processes of regulatory conversations be entered into, regulations may be adopted in a manner which limits the costs on the industry, with the industry, in turn, understanding and appreciating further the objectives of the law and possibly also contributing, through its own methods, to reaching these same objectives. Unfortunately, however, the Basel Accords have emerged simply through transnational regulatory agencies without resorting to proper "regulatory conversations" and have both developed as a response to, and also given rise to further widespread regulatory arbitrage.

#### ***4.4 Regulatory Competition and the Use of Treaties***

Notwithstanding that states get together to form an international community and that they liaise with international institutions to reach the universal goals of having a stable economic system, reduce systemic risks, and have regulatory convergence, one must also consider that different states compete against each other for business. Therefore, whilst states negotiated and agreed to the Basel Accords, these same states (and others which adopted the Basel Accords due to market pressures) are tasked with adopting, implementing and enforcing the Basel Accords in full knowledge that the more regulatory strains are imposed, the worse-off they will be.

It has been stated that competition amongst governments can be defined as rivalrous behaviour in which each government attempts to win some scarce beneficial resource or to avoid a particular cost<sup>549</sup>. Competition between states typically takes place either through the use of (or lack of) taxes and other fiscal measures, through regulatory powers which the state may have, and through the way in which certain regulations may

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<sup>548</sup> Roy Goode, *Harmonised Modernisation of the Law Governing Secured Transactions: General-Sectorial, Global-Regional: An Overview* (Uniform Law Review, Vol 8, 2003-1/2, UNIDROIT, 2003) 345.

<sup>549</sup> Daphne A Kenyon and John Kincaid, 'Introduction' in Daphne A Kenyon and John Kincaid (eds.), *Competition Among States and Local Governments* (The Urban Institute Press, 1991) 2.



be adopted, implemented or enforced<sup>550</sup>. The attractiveness of states may also depend on regulatory capture which occurs between the state and the particular industry participants, as industry participants seek to convince national regulatory agencies in order to adopt certain approaches which may be beneficial to the said industries<sup>551</sup>. A literature review has therefore been carried out in relation to how states behave in a regulatory competitive environment, and in order to argue that given the current regulatory competitive framework, a Treaty on the main principles of the Basel Accords should be resorted to in order to avoid a race to the bottom.

It has been argued by Price that though three different theories as to how and why the Basel Accords were established have been put forward (being that states act as a “*single community*”; that states act out of their own “*self-interest*”, and that the Basel Accords follow on “*regulatory capture*”), he argues that it is only the “*self-interest*” theory which has continuously contributed to the substance of the Basel Accords<sup>552</sup>. This is therefore consistent with economic analysis which considers rational actors to act out of their own self-interest as referred to in this thesis.

In light of the “*self-interest*” adopted by states, Price draws upon “*game theory*” to explain how states, as rational actors (and behaving strategically) whilst having different goals and preferences, have negotiated the Basel Accords<sup>553</sup>. Furthermore, it is argued that game theory concepts have also continued to apply throughout the years in the way in which the Basel Accords have been implemented in practice, particularly as states operate as entities adopting strategic behaviour and in competition with other jurisdictions.

Price has pointed out how in game theory two elements are important, being the alternative feasible individual welfare levels of each party; and the welfare levels of the different parties at breakdown point (i.e. at the point in time where cooperation is no longer possible)<sup>554</sup>. He notes how if a party’s breakdown point is stronger than that of the other parties, the bargaining solution will end up being more favourable to such

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<sup>550</sup> *ibid.*

<sup>551</sup> *ibid.*

<sup>552</sup> Sam Price, ‘Bargaining Theory and the Formation of International Financial Regulation: A Study of the Basel Accords’ in Damiano Brigo, Peter Springett, and Sam Price (eds.), *The Capco Institute Journal of Financial Transformation* (Cass-Capco Institute Paper Series on Risk, Vol. 41, June 2015) 38.

<sup>553</sup> *ibid* 39.

<sup>554</sup> *ibid.*

stronger party<sup>555</sup>. He also notes how in considering the “*breakdown point*” one also needs to consider what the position would be on the breakdown of negotiations for each individual party if the different states would have failed to agree to cooperate, with this also being dependent upon what the actions of other states would be in such a scenario<sup>556</sup>.

Lee also argued that there is a connection between transnational regulatory networks such as those establishing and implementing the Basel Accords and game theory particularly since those states which agree to be bound by certain international financial regulations may still opt out of these standards<sup>557</sup>. She notes how these states act in this way in order “*to maintain the competitive edge of their respective domestic financial markets, fearing that higher regulatory standards may harm foreign investment opportunities and thus their respective domestic economy*”<sup>558</sup>.

Thus, it is here also contended that a strategic approach is also adopted by states in implementing and enforcing the Basel Accords (rather than solely in the negotiations leading to the agreed texts of the Basel Accords): whilst states need to be seen to be adhering to the Basel Accords in light of the pressure which the market and international organisations apply, states may attract more business if they manage to cater for the specific goals of the industry. Thus regulatory arbitrage arises in light of the way in which different states adopt different approaches towards the Basel Accords.

Trachtman has argued that, in strategic trade theory, if rents are to be captured between competing states, such competition might not result in there being optimal regulation, but merely in regulation that seeks to win the competition for rents<sup>559</sup>. Thus, in light of game theory structures, states may reduce the level of regulation below what they would otherwise consider as optimal in order to attract investment<sup>560</sup>.

It has therefore been stated that the prevailing consensus is that competition among states and local governments has predominantly negative effects as this can lead to inadequate measures taking place and/ or a waste of resources as governments seek to

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<sup>555</sup> *ibid.*

<sup>556</sup> *ibid* 39 – 40.

<sup>557</sup> Emily Lee, *The Soft Law Nature of Basel III and International Financial Regulations* (Journal of International Banking Law and Regulations, Vol 29(10)) 8 <<http://ssrn.com/abstract=2553666>> accessed 1 February 2017.

<sup>558</sup> *ibid.*

<sup>559</sup> Joel P Trachtman, *Regulatory Competition and Regulatory Jurisdiction* (Journal of International Economic Law, OUP, 2000) 336.

<sup>560</sup> *ibid.*

attract business from other jurisdictions which will result in a zero-sum game<sup>561</sup>. Trachtman thus argues that in order to prevent an unstable competitive process from degenerating, a hegemonic power would need to take over regulation, with that hegemonic power possibly also being an international organisation (rather than a state)<sup>562</sup>. On the other hand, however, Trachtman also argues that interjurisdictional externalities do not always require centralization and that market-type mechanisms may be the most efficient way in which these interjurisdictional externalities are internalized<sup>563</sup>. He however notes that certain externalities may not be internalized because of the transaction costs and the strategic costs involved<sup>564</sup>.

It has also been argued that harmonisation of certain regulations may also be established by states acting as a “*cartel*” in providing regulation<sup>565</sup>. However, in the same way as in a cartel, the biggest costs here would be in enforcing such cartel, as in such a scenario, a participant stands to benefit in lowering the standards provided slightly, in order to benefit over other members of that same cartel. The main risk which would arise in such circumstance is that states may steer away from a cartel, as they seek to benefit from the high standards adopted by all participants, and with this quickly degenerating into a “*race-to-the-bottom*”. On this basis Carey has argued that the ideal solution to the lowering of corporate standards was that of adopting federal “*minimum standards*”, thereby eliminating competition between states and the consequent race to the bottom<sup>566</sup>.

It has been stated that on assessing the political risk of non-compliance with transnational laws and regulations, game theory may “*well counsel towards the use of treaties, rather than other forms of harmonised rules*”, given the principles surrounding Treaties and the legal obligation states have in giving effect to such Treaties<sup>567</sup>. It is therefore here submitted that Treaties are more appropriate in order to achieve

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<sup>561</sup> Kenyon and Kincaid (n 549) 2.

<sup>562</sup> Trachtman (n 559) 339 – 340.

<sup>563</sup> *ibid* 342.

<sup>564</sup> *ibid*.

<sup>565</sup> *ibid* 347.

<sup>566</sup> Albert Breton, ‘The Existence and Stability of Interjurisdictional Competition’ in Daphne A Kenyon and John Kincaid (eds.), *Competition Among States and Local Governments* (The Urban Institute Press, 1991) 44.

<sup>567</sup> Wool 2003 (n 5) 393.

international financial regulatory law reform given that Treaties give rise to high compliance incentives since non-performance violates international law<sup>568</sup>.

Dalhuisen similarly argues that if states do not adhere to international standards, and if peer pressure is not sufficient, this may lead the international community to push for the establishment of Treaty law in order to ensure the enforceability of the established norms<sup>569</sup>. Thus he argues that uniform treaty law (as an international cooperation agreement which should have binding effect on all parties) should only be entered into at the request of the international legal order itself in order for it to be likely to succeed, and he argues that this is the reason why many UNCITRAL and UNIDROIT initiatives have not been taken up further by states notwithstanding the efforts made<sup>570</sup>.

Consequently, in light of the ever present regulatory competition which exists, Chapter 9 will argue in favour of a more formal approach to the Basel Accords through the adoption of binding principles through instruments which have legal force (such as through the use of a Treaty), rather than relying on soft-laws for the adoption of regulation such as the Basel Accords. Such a Treaty should however be limited to the main principles which are to be followed, whilst recognising that regulatory competition on the finer details still takes place. This would allow states to compete openly on regulation, whilst always having a safeguard that the minimum principles which would have been agreed to transnationally would be respected by all, and that there would be legal obligations to do so at an international and transnational level.

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<sup>568</sup> Wool 2012 (n 5) 635.

<sup>569</sup> Jan H Dalhuisen, *The Operation of the International Commercial and Financial Legal Order: The Lex Mercatoria and its Application – Moving from the Theories of Legal Positivism and Formalism to the Practicalities of Legal Pluralism and Dynamism* (European Business Law Review, 2008) 1019.

<sup>570</sup> *ibid* 1042.

## **Chapter 5: Regulatory Arbitrage as a Consequence of Self-Interest**

Chapter 4 has argued that the Basel Accords have only developed as a consequence of hegemonic influences and as a response to the need for regulators to be seen to be doing something following the global financial crisis, and that no economic analysis has been carried out on the underlying principles of the Basel Accords. It has also been shown in Section 2.3 that states (acting individually) and the industry have their own interests which do not necessarily correspond with the interests of the international community. Furthermore, the interests of national regulators may also be drawn close to the interests of the industry through regulatory capture (and therefore possibly even further away from the interests of the international community).

The lack of consideration of the interests of the individual nation states and of the industry as separate actors, severely limits the effectiveness of the Basel Accords and the possibility of the aims of the said Basel Accords being reached. As states and as the industry consider the Basel Accords to have negative effects on their own self-interest, each of the individual nation states and the industry, seek ways to minimise the effects of the Basel Accords. The costs faced by states as a result of the Basel Accords, and the utility states (acting individually) obtain by lowering standards will therefore be considered below.

As a result it is here argued that in light of the lack of consideration of the utility which the different actors obtain from the Basel Accords, regulatory arbitrage is resorted to, whereby the industry finds ways through which it shifts its activities to unregulated entities in order to avoid or minimise the costs of regulation. The lack of regulatory convergence amongst states and the lack of regulatory consistency in relation to different types of entities, allows industry participants to reduce the costs of regulation on them, but at the added cost for the wider community of reducing the effectiveness of the Basel Accords.

This Chapter also argues that regulatory arbitrage may also create an element of over-regulation in the standards set by the Basel Accords, thereby further fuelling the argument that it may be more opportune to move towards a regulatory competitive environment.

## ***5.1 Costs Faced by States as a Result of the Basel Accords***

Limitations imposed by the Basel Accords tend to give rise to costs to the economy as a whole (and particularly to the industry), as discussed in further detail in Chapter 4. However, as the costs of financial entities rise this may also become a problem for states (and their national regulators), as the industry participants in a particular state may find themselves in a worse position than before the adoption of the said standards. Furthermore, national regulators also face problems as industry players exit the industry, move to less-regulated jurisdictions, or stop providing particular lines of business.

It has been stated that the Basel Accords (and particularly Basel II and Basel III) are too complex and put smaller firms at a disadvantage, thereby also restricting new entrants to the market (particularly in light of the wider opportunities larger banks are presented with)<sup>571</sup>. The lack of provision of finance by smaller firms leads to a shift in the financing role to non-bank entities which fall outside the scope of the Basel Accords or the regulatory framework<sup>572</sup>.

Another cost which national regulators have been faced with is that the Basel regime has been criticised for not adequately providing for long-term financing given that the underlying presumption of the Basel Accords is that banks are to correlate short term deposits with short term loans<sup>573</sup>. As a result, banks cannot realistically provide long-term financing for projects which require the cost of capital to be spread out over longer periods<sup>574</sup>. Long-term financing requires long-term capital in place, whilst keeping more funding in reserves than the amount which would have been lent out<sup>575</sup>. Nevertheless projects which require long-term finance may be important projects for an economy and this may therefore be seen as a fundamental problem for states. The presumption adopted by the Basel Accords is also ambiguous in light of the maturity transformation role which banks are known to undertake.

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<sup>571</sup> Kline Alan, *Basel III Should be Scrapped, Hoenig Says* (AM Banker, 14 September 2012) <[http://www.americanbanker.com/issues/177\\_179/basel-iii-should-be-scrapped-says-hoenig-1052668-1.html](http://www.americanbanker.com/issues/177_179/basel-iii-should-be-scrapped-says-hoenig-1052668-1.html)> accessed 4 October 2014; Wood (n 1) 663 – 664.

<sup>572</sup> Lloyds TSB plc, *Response to the Consultative Document on the New Basel Capital Accord* (Basel Committee on Banking Supervision, 31 May 2001) 3 <<http://www.bis.org/bcbs/ca/lotsbgrp.pdf>> accessed 2 October 2014.

<sup>573</sup> Angelo L Rosa, *Weathering the Tempest: The Impact of the Basel III Capital Accord on Asset Finance* (The Tennessee Journal of Business Law, Vol. 14, 2013) 184 – 187.

<sup>574</sup> *ibid.*

<sup>575</sup> *ibid.*

The Basel regime has also been criticised for being too rigid and using static concepts, such as for example risk-weighted assets, whereby the ratings attributed to particular assets do not move along with the economic cycle and do not give incentives to banks to re-price risk when economic conditions are improving or deteriorating<sup>576</sup>. In this sense it has been stated that compliance with rules might lead to a false sense of security if the rules alone are followed – though credit analysis itself is highly judgmental in nature, any such analysis needs to take into consideration economic forecasts and unforeseen crises<sup>577</sup>.

It has also been argued that the Standardised approach adopted by the Basel Accords tends to favour loans being extended to the worst borrowers<sup>578</sup>. Given that unrated corporates are generally all given the same treatment by the Basel Accords, irrespective of the credit risk they pose, banks may prefer to lend to riskier unrated corporates (when compared to other unrated corporates) given that this can justify higher interest rates and with the bank therefore hoping that this can also result in higher profits<sup>579</sup>.

One must also note that the IRB approach was previously untested, since this system was developed entirely during the international negotiations on the Basel Accords, with regulators therefore taking a “*leap of faith*” when adopting this IRB methodology<sup>580</sup>. This IRB methodology has been described by Wood as “*like driving down a road looking into the rear view mirror and is pro-cyclical*”, whilst arguing that in an economically benign climate credit losses reduce, leading to low capital requirements, whereas as soon as the cycle turns down, loan losses will lead to an increase in the capital requirements<sup>581</sup>. As a result this means that there is no provisioning taking place when losses are incurred, and capital requirements must be increased when the financing entity is considered to be the most vulnerable.

The introduction of liquidity standards in Basel III has also been criticised in light of the constraints it places on banks and the additional ratios it requires banks to apply. Though the liquidity coverage ratio was adopted in order to seek to create a buffer against banks’ insolvency, as from August 2012 even the ECB started advocating against

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<sup>576</sup> Morten (n 124) 82; Wood (n 1) 663 – 664.

<sup>577</sup> Wood (n 1) 663 – 664.

<sup>578</sup> Gabbi and others (n 454) 55; Schooner (n 179) 168; Morten (n 124) 65 – 66, 71; Tarullo (n 21) 80.

<sup>579</sup> *ibid.*

<sup>580</sup> Tarullo (n 21) 6.

<sup>581</sup> Wood (n 1) 663 – 664.

stringent liquidity requirements in light of the negative economic effects which this was bound to create due to the contraction of capital which this results in<sup>582</sup>.

## ***5.2 Utility Obtained by States and Incentives to Lower Standards***

As discussed above, though there are three main actors in the Basel Accords, the main goal of reducing global financial stability and having global regulatory convergence only lies with the international community. This thesis assumes that individual nation states have goals which vary from that of the international community, with the goals of states being that of attracting business and increasing financial activity in such a way which can keep the state's subjects (which include the industry) satisfied.

States are therefore faced with a prisoner's dilemma – whilst knowing that the greatest gains for all will be obtained through there being international harmonization of rules and continued regulatory co-operation, they tend to adopt policies which maximise their own self-interest and act in a protectionist manner (possibly also impacting international financial stability), knowing that this may provide short-term advantages<sup>583</sup>. Tietje and Lehmann have thus compared the international financial system to the international trading system, concluding that the situation in the international financial system is very similar to that found in competition law<sup>584</sup>. One should here also note that Goldsmith and Posner had also referred to there being a “*prisoner's dilemma*”, and they considered this as being one of the reasons as to why states typically seek to comply with international law, and this particularly out of fear of retaliation by other states<sup>585</sup>.

When dealing with international markets and the international trading system it has been argued by authors such as Ruggie, expanding on the works of Polanyi, that states are primarily engaged in “*embedded liberalism*”, whereby states seek to carve out a balance between having free trade, whilst at the same time acting in their self-interest, in order to cater for domestic social needs (and particularly in light of the fact that this is where a Government's legitimacy comes from)<sup>586</sup>. It is here argued that though in the international trading system, protectionist measures need to be put forward *a priori* by the relevant actors (due to the binding nature of the relevant international agreements),

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<sup>582</sup> Rosa (n 573) 182.

<sup>583</sup> Tietje and Lehmann (n 149) 678; Verdier 2009 (n 10) 125.

<sup>584</sup> Tietje and Lehmann (n 149) 678.

<sup>585</sup> Goldsmith and Posner (n 443) 467.

<sup>586</sup> Ruggie (n 193).



when dealing with soft-law established through transnational regulatory networks, self-interest of different states can afford to be dealt with at later stages (such as on implementing the relevant agreements in national law), in light of the non-binding nature of the said international standards. Furthermore, this becomes even more relevant in light of the quest for states to adopt further protective measures following the global financial crisis.

On harmonisation of laws, states may agree to adopt rigorous rules, knowing that if all states adopt the same rules, they need not be concerned about competitive issues. Thus, as the international community agrees to harmonise rules, the standards which may be agreed to within the international community may be set above the “*optimum*” level of regulation. Benston has therefore argued against full harmonisation of rules, and prefers to adopt a regulatory co-operative approach which would be coupled with giving leeway to national regulators, in light of the fact that full harmonisation of rules might result in the importation of rules which might be too extensive or intrusive<sup>587</sup>.

Harmonising rules at a higher level than the “*optimum*” level will lead to further costs to society, such as increases in the costs of the operation of regulators, and increases in the costs of regulated entities on seeking to understand and deal with the regulation imposed on them<sup>588</sup>. This may also lead to other problems, such as the problem of economic moral hazard (where entities ignore any default risk and just seek higher returns in light of the excess regulation and in light of other schemes such as deposit insurance schemes), as well as infantilization, (where in light of the elaborate regulatory systems, regulated firms feel that they are sufficiently protected, and hence may even result in acting irrationally, with the phrase being coined which may be applicable in such scenario being “[t]reat people like children and they will behave like them”)<sup>589</sup>. Furthermore, over-regulation may also inspire amoral behaviour, particularly through regulatory arbitrage, as firms may just become concerned with whether particular structures fall within established frameworks and within the “*rules*”, rather than seeing whether they comply with the spirit of the rules and whether the procedures they adopt make legal, economic, and financial sense and undergo a proper analysis of the risks at hand<sup>590</sup>.

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<sup>587</sup> Benston (n 111) 117 – 118.

<sup>588</sup> Alistair Alcock, *Are Financial Services Over-Regulated?* (Company Lawyer, Sweet and Maxwell, 2003) 136.

<sup>589</sup> *ibid* 136 – 137.

<sup>590</sup> *ibid* 137.

On considering the supply of “*regulation*” by regulators, parallels can also be drawn to the theory of cartels, as states agree to co-operate in order to provide somewhat homogenous regulations in what could alternatively be seen to be a liberally competitive market between states<sup>591</sup>. As suppliers would, in cartels, join together to harmonise their products and their respective prices, similarly transnational laws such as the Basel Accords provide national regulatory agencies with an opportunity to increase the onerousness of the regulation they impose on industry players (to a more onerous standard than that which would otherwise apply in a competitive scenario), given that this will result in better regulatory standards which would be harmonised amongst all participants, without there being negative effects on a state’s competitiveness, as all jurisdictions would be imposing the same onerous requirements<sup>592</sup>.

Nevertheless, as the theory of cartels states, on there being harmonisation, there will be a great incentive for participants to “*price*” their products slightly below the agreed value, since this will then give a defector further profits as pricing products slightly below the agreed value would result in a massive swing in demand given that that entity would be more competitive than all other participants who would be following the rules of the cartel. Thus as one entity does not follow the rules of the cartel, that entity will make super-profits given that products would still be supplied at a very profitable rate, but with that entity still having a very high demand for products at that rate, in light of the market positions of other market players.

Similarly, jurisdictions may be tempted to set the standards of their regulations to be slightly below the standard set by transnational regulatory laws, in order to be able to

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<sup>591</sup> See by way of example: Richard A. Posner, *Theories of Economic Regulation* (Bell Journal of Economics and Management Science, Vol. 5, No. 2, Autumn 1974) 344 – 345.

<sup>592</sup> One should not here simply apply the concepts of “*demand for regulation*” and “*supply of regulation*” as put forward by Stigler, in that Stigler’s main focus was on the influences which regulated industries had on the provision of regulation and how they may push for implementation of regulation which may be used in their favour, particularly in order to limit new entrants to the respective markets. The situation contemplated here is different: influences over the “*demand for regulation*” are varied as industry participants may be hesitant to apply regulatory laws if such laws are seen to solely impose new forms of restrictions on their respective activities, whilst industry participants may also encourage States to “*defect*” from the international standards. On the other hand global firms can seek to influence international policies, though the various interests in play in such transnational networks makes this more difficult. Furthermore, the objective for “*supplying regulation*” here is also different in that the objectives of States may vary: States may wish to supply regulation in accordance with the international standards in light of the effects on their markets; other States may however opt for a more protectionist view in light of the influences by local industry and regulatory capture. See: George. J. Stigler, *The Theory of Economic Regulation* (The Bell Journal of Economics and Management Science, Vol. 2, No. 1, Spring 1971); Benston (n 111) 91.

benefit from having a competitive edge over all other jurisdictions, whilst still maintaining higher standards than those which would otherwise apply in a competitive environment. Pan states that “[t]o the extent national regulators operate independently of one another, they will always face competitive pressure and must be prepared to implement regulatory strategies that make their markets more attractive”<sup>593</sup>.

This can similarly be seen in relation to the Basel Accords. While initially Basel I was successful, by having ensured that bank capital levels increased, after some time national regulators sought to exploit regulatory arbitrage opportunities in order to provide a competitive edge over other jurisdictions, with the BCBS being powerless given the absence of supervisory or enforcement mechanisms<sup>594</sup>. Hyoung-Kyu has also noted that “*though external pressures – either from foreign states or from the markets – may induce formal standards compliance, they are likely to be much less effective in restricting cosmetic compliance*”<sup>595</sup>.

The main problem with states having incentives to lower their regulatory standards would be that if the number of “defectors” becomes substantial, then the whole system falls through as the harmonised “prices” or “regulation” can no longer be justified, with this leading, in terms of regulation, towards a competitive environment and a potential “race to the bottom” as states compete against each other.

### ***5.3 Regulatory Arbitrage and its effects on Regulatory Competition and on the Basel Accords***

As both individual nation states as well as the industry have incentives to look towards their self-interests, and in light of the gaps which exist in regulation, regulatory arbitrage has been resorted to in order to minimise the costs which the Basel Accords impose on the industry. It has been argued that the Basel Accords have facilitated regulatory arbitrage by allowing “*significant discretion in state implementation*” as well as a result of the lack of clarity and specificity within the terms of the Basel Accords<sup>596</sup>. Regulatory arbitrage has therefore allowed the industry to find ways around the strict measures required by the Basel Accords.

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<sup>593</sup> Pan (n 110) 800 – 801.

<sup>594</sup> Verdier 2009 (n 10) 133.

<sup>595</sup> Hyoung-kyu Chey (n 122) 3.

<sup>596</sup> Lyngen (n 76) 524, 526.

Riles has noted that “*legal literature on regulatory arbitrage is surprisingly thin*”, with commentators generally describing certain laws or regulations as “*leading to regulatory arbitrage*”, and with this being generally seen as an “*obvious rationale for legal harmonization*”<sup>597</sup>. She has described this as being a practice whereby “*value is created by seeking out and eliminating arbitrary differences between functionally equivalent assets*”<sup>598</sup>. Riles notes that regulatory arbitrage therefore requires there to be two different elements<sup>599</sup>:

- a similarity (functional or economic) amongst the financial products being used such that one financial product can act as a substitute for another with the two being somewhat interchangeable; and
- a formal difference in law or regulation which continues to exist throughout the use of the product which can account for a difference in price or costs through the use of that product instead of its substitute. This difference should be great enough in order to yield a profit to an arbitrageur once all the costs of the regulatory arbitrage are taken into consideration.

It has been stated that prudential rules will always give rise to a risk of regulatory arbitrage, and that even a process of harmonization may lead to regulatory arbitrage opportunities as different jurisdictions adopt different paces in changing their laws and regulations, with financing entities generally also always being one step ahead of regulators<sup>600</sup>. Riles has adequately described the problem of regulatory arbitrage (which in this example refers particularly to the use of shadow banks) in financial regulation (not limited to the Basel Accords), particularly following the recent global financial crisis on saying<sup>601</sup>:

*In the world of financial regulation, national financial regulators confront a global financial system. Since 2008, regulators have made concerted efforts to address the national regulatory differences that made AIG's trades possible in the first place. New rules hammered out at multiple G20 summits since 2008 seek to address how these global challenges apply to banks. How have the markets*

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<sup>597</sup> Riles (n 46) 68.

<sup>598</sup> *ibid* 70; See also: Engert (n 308) 357 – 358.

<sup>599</sup> Riles (n 46) 70 – 71.

<sup>600</sup> *ibid* 66, 83; Johann Jacobs and Gary van Vuuren, *Applying Lessons Learnt from Deficiencies in the Basel Accords to Solvency II* (Journal of Economic and Financial Sciences, July 2013, Vol. 6(2), 2013) 320.

<sup>601</sup> Riles (n 46) 64, 65.

*responded to these rules? Financiers have simply found ways of booking their transactions through non-bank institutions, known as shadow banks, which are not subject to the G20's rules. The Financial Stability Board not surprisingly has responded by hammering out new rules to govern shadow banks. And yet before these rules even come into operation, market participants are busy devising new kinds of exceptions.*

*The ability of financial institutions to act beyond the reach of regulators threatens the sovereignty of nation-states and the well being of national economies. Yet as regulators are aware, the threat is possible only because of differences in national regulatory regimes.*

It has been noted that regulatory arbitrage thrives on there being different legal regimes and different legal requirements, particularly when this takes place through systems which are not clear and coherent and where there is lack of coordination amongst regulators<sup>602</sup>. As long as similar economic activities attract different types of regulation, with different costs being associated with these variances in regulation, firms will seek to maximise their utility by resorting to regulatory arbitrage. Firms, as rational actors, have as their main goal the making of profits for the benefit of the firm and its shareholders or promoters. A financing entity, which is the subject of capital adequacy and liquidity restrictions, is therefore economically justified in trying to adopt measures through which its returns and profits will be maximised and through which the least costs would be incurred. A firm's goals vary from the goals of the transnational regulatory bodies, and whilst the rationale for having the Basel Accords is in order to ensure financial stability and reduce systemic risk, this is not necessarily a priority for financing entities. Furthermore as the goals of individual states may also vary from the goals of international regulation, this may mean that firms and states may collude (also through regulatory capture) in order to arbitrage international financial regulation, particularly if this means that states may attract further business, and if regulatory arbitrage could lead to there being higher profits for the industry.

Heremans and Paccès argue that the “*dynamics of regulation boils down to a continuous tension between the desire for a stable financial system and an economic efficient system*”<sup>603</sup>. They however further importantly note that<sup>604</sup>:

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<sup>602</sup> *ibid* 72.

<sup>603</sup> Heremans and Paccès (n 330) 31.

<sup>604</sup> *ibid*.

*regulatory arbitrage provides an important lesson for financial regulation: the more regulation is insisting on disciplining certain forms of financial intermediation, the stronger private incentives will be to develop financial innovation potentially harmful for financial stability.*

Barry observes that regulatory arbitrage takes place in light of the established legal rules not accurately tracking the economic substance of transactions, with regulation therefore failing to take economic realities into account<sup>605</sup>. He thus states that regulatory arbitrage is not necessarily problematic, given that it may remove or lower socially undesirable burdens, such as social costs and transaction costs<sup>606</sup>. Thus, though regulatory arbitrage allows one to avoid financial regulation this is not necessarily a negative consideration. The fact that similar economic activities attract different regulatory considerations can mean that either:

- (a) there is a mismatch in the regulation such that there is an element of over-regulation: if “*economic activity A*” and “*economic activity B*” have the same economic effects, and if heavy regulation is imposed on “*economic activity A*” but not on “*economic activity B*”, then one may argue that the regulation imposed on “*economic activity A*” is an unnecessary social cost, given that there would be no issues with having the similar “*economic activity B*” being subject to less regulation. It is therefore economically efficient, and desirable, from an economic perspective, for firms to make use of regulatory arbitrage in order to avoid the regulation imposed on “*economic activity A*”; or
- (b) one type of economic activity is more desirable than another such that regulation seeks to create incentives (or nudge<sup>607</sup>) for the transfer of risk by using one type of economic activity over another. Here one would assume that one course of action is beneficial to society, whilst the other course of action is detrimental society. Thus regulatory arbitrage is here seen as a positive thing in that firms make use of the more socially desirable method.

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<sup>605</sup> Jordan Barry, *On Regulatory Arbitrage* (Texas Law Review See Also, Vol. 89, 2010) 73 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1859750](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1859750)> accessed 28 February 2016.

<sup>606</sup> *ibid* 73 – 74.

<sup>607</sup> Sunstein and Thaler define a “nudge” as “*an aspect of choice architecture that alters people’s behaviour in a predictable way without forbidding any options or significantly changing their economic incentives*”; See: Cass Sunstein and Richard Thaler, *Nudge: Improving Decisions About Health, Wealth and Happiness* (Penguin Books, 2008) 6.

In each of these two instances, regulatory arbitrage has a positive effect, and it may be argued that these two types of regulatory arbitrage are generally present on there being a regulatory competitive environment in place.

It is here argued that the mismatch in regulation arising out of the Basel Accords arises not out of incentives which states wish to create, but due to the lack of a proper cost-benefit and economic analyses adopted throughout the years and due to the fact that in the past the main method of financing was bank financing such that previous crises have emanated from banks. This has therefore led to the Basel Accords focussing solely on bank-financing, and ignoring other unregulated alternative methods of financing to which risk is being transferred. Notwithstanding the stringent and rigorous rules which the Basel Accords apply over “*internationally-active banks*”, and notwithstanding that different jurisdictions have extended the said Basel Accords to other entities, non-banks and shadow banks carrying out the same economic function as banks are still not subject to the requirements of the Basel Accords (and with investment firms being subject to varying regimes) as described in Chapter 3 to this thesis. This type of regulatory arbitrage is not desirable, however, as it encourages a shift from the regulated to the unregulated sectors, thus allowing the risks which the Basel Accords sought to prevent, to take place. This also gives rise to the question as to whether the Basel Accords are an unnecessary social cost on banks, given that regulators are tolerating the transfer of the same activities carried out by banks, and the transfer of similar risks which the Basel Accords seek to protect against, to entities which are not subject to the Basel Accords.

As discussed in Section 3.5, as the main objectives of the Basel Accords have developed along the years, the problem of regulatory arbitrage has been put to one side (as the importance of regulatory convergence has diminished over the years), only to have become a major problem once again. Whereas the initial rationale for having the Basel regime in the first place was in order for there to be regulatory convergence, the situation is currently such that regulatory arbitrage opportunities continue to be a major concern, and though systemically important banks are subject to similar rules, different rules still apply between different types of banks in different jurisdictions (albeit consolidation of laws through maximum harmonisation at EU level); between banks and investment firms in different jurisdictions; and between banks and other entities which carry out shadow banking activities, amongst others<sup>608</sup>. Therefore as the focus in the

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<sup>608</sup> See also: Blundell-Wignall Adrian and Atkinson Paul, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity* in “Financial Market Trends” (OECD, Vol. 2010, Issue 1, 2010) 13 – 14.

Basel Accords shifted from “*regulatory convergence*” to that of reducing “*systemic risks*”, the regulatory arbitrage opportunities resulting from the lack of convergence (such as through shadow banking) are in themselves becoming a source of systemic risk (particularly also in light of its interconnectedness with the conventional banking system)<sup>609</sup>. This has also been recognised by the FSB which noted that “[t]he instruments, markets, and entities that make up the shadow banking system are often complex and have historically been outside the focus of authorities for purposes of identifying and monitoring systemic risk and regulatory arbitrage”<sup>610</sup>.

It has been argued that “*regulatory arbitrage*” can only be avoided if “*the rules across all legal systems are harmonized*” and hence that the “*regulatory cost of transacting is identical globally*”, though it has been acknowledged that achieving this may be “*extremely contentious*” particularly in light of different interests of different states<sup>611</sup>. The lack of convergence between prudential arrangements in the major economic blocs, such as the US, the EU, and Asian jurisdictions, can therefore distort competition and encourage regulatory arbitrage, at the risk of financial stability<sup>612</sup>.

In addition to the above, and in light of the costs incurred by entities subject to the Basel Accords, entities which fall outside the regulatory scope of the laws and regulations implementing the Basel Accords not only have an advantage when competing with entities which are subject to the Basel Accords, but the difference in the laws and regulations actually encourages the latter to transfer their risks and their riskier activities to the former in light of them being subject to lighter regulation and lower costs (with this also being discussed in further detail in Section 5.4)<sup>613</sup>. Jacobs and van Vuuren have therefore argued that as banks seek to maximise shareholder value they necessarily seek to find ways in which to save on capital requirements and be more competitive than other banks through regulatory arbitrage<sup>614</sup>. It has been argued that on there being divergences in regulation between banks and non-banks, with banks being subject to further regulation than non-banks, there will be a corresponding shift in the amount and nature of business conducted towards the shadow banking (“*non-bank*”)

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<sup>609</sup> FSB April 2011 (n 310) 1.

<sup>610</sup> *ibid* 6.

<sup>611</sup> Riles (n 46) 65 – 66.

<sup>612</sup> Choulet (n 335) 3.

<sup>613</sup> *ibid*.

<sup>614</sup> Jacobs and van Vuuren (n 600) 319.



system<sup>615</sup>. This has also been the subject of an example given by Riles on seeking to define “*regulatory arbitrage*”, who has stated<sup>616</sup>:

*A simple example is the case of an offshore non-bank entity that provides the same investment services to U.S. investors as an investment bank, and yet is not subject to G20-mandated capital adequacy requirements. These capital adequacy requirements are intended to cushion the bank against the risk of failure, but the offshore non-bank entity is not subject to them – both because it is located offshore and because it is not a bank according to the G20’s definitions. This offshore non-bank entity pockets the substantial savings it incurs, relative to regulated banks, from not having to hold so much capital on reserve in order to sell its investment services to U.S. investors.*

It has therefore been stated that “[a] basic problem with the Basel system is that it cannot deliver a regulatory ideal of treating the same promises in the financial system in the same way wherever they are passed in the regulatory and tax arbitrage process”<sup>617</sup>. The difference between the types of entities to which the Basel Accords apply across the globe, particularly the difference in the applicability of the Basel Accords to investment firms and shadow banks has therefore been seen as a cause of concern<sup>618</sup>.

Given the divergent methods of implementation of the Basel regime the BCBS launched the “*Basel III Regulatory Consistency Assessment Programme*” in April 2012, in order to analyse the different jurisdictions implementing the Basel Accords, in order to ensure a timely adoption of the Basel III standards, achieve regulatory consistency with Basel III, and also ensure the consistency of outcomes across different jurisdictions<sup>619</sup>. It is therefore clear that whilst “*regulatory convergence*” is no longer considered to be the main objective of the Accords, the lack of convergence will cause issues and arbitrage opportunities. The problem with this however remains that this programme will not analyse whether the current Basel rules are causing a shift in risk to other unregulated activities which fall outside the regulatory scope of the Basel Accords.

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<sup>615</sup> Blundell-Wignall and Atkinson (n 608) 13 – 14; Herring (n 355) 277.

<sup>616</sup> Riles (n 46) 70.

<sup>617</sup> Blundell-Wignall and Atkinson (n 608) 13 – 14, 21.

<sup>618</sup> This has also been seen as a concern at European Union level. See: David Howarth and Lucia Quaglia, *Banking on Stability: The Political Economy of New Capital Requirements in the European Union* (Journal of European Integration, Taylor & Francis, 2013) 337 <<http://dx.doi.org/10.1080/07036337.2013.774780>> accessed 21 November 2014.

<sup>619</sup> See: Basel Committee on Banking Supervision, *Basel III Regulatory Consistency Assessment Programme (RCAP)* (October 2013) <<http://www.bis.org/publ/bcbs264.htm>> accessed 16 December 2014.

One of the reasons for this might also be due to the fact that the Basel Accords have always been set out as “*minimum standards*”, allowing different jurisdictions to build upon these standards as they required<sup>620</sup>. Furthermore certain matters, such as decisions on which banks are to adopt the IRB approach, are also subject to national discretions<sup>621</sup>. This is also enhanced by the fact that the scope of application for the purposes of the BCBS still remains that of “*internationally-active banks*” with the aim of reduction of systemic risks being only considered insofar as these arise out of the said “*internationally-active banks*”. The BCBS therefore does not consider whether the systemic risks it is seeking to avoid are being shifted onto lesser regulated or unregulated financial entities to which the Basel Accords do not apply (and do not fall within the traditional understanding of what constitutes a “*bank*”), either through a lack of regulatory convergence or through a lack of competitive equity between different financial instruments.

This has been further complemented by differences in how the Basel Accords themselves have been implemented. By way of example in the US, only the Advanced IRB approach was adopted initially<sup>622</sup>, with the Standardised approach only being adopted on the implementation of Basel III (with this also acting as a “*capital floor*” for banks adopting the Advanced IRB approach and without there being any reference to the Foundation IRB approach). On the other hand in Hong Kong a fourth variant called the “*basic approach*” was also added to the “*standardized*” approach and to the two IRB approaches<sup>623</sup>. Another example of such a variance would be that, through the Dodd-Frank Act, the US omitted reference to ratings obtained from credit rating agencies, and instead adopted an approach whereby alternative standards of credit worthiness are referred to<sup>624</sup>.

It is perhaps somewhat telling that even in the EU, the CRD IV draft was also criticised by many regulators and by the IMF for having significantly watered down a number of key elements of Basel III – such that the British Treasury Minister has been reported as

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<sup>620</sup> Basel I (n 261) 1 para. 1; Basel II (n 264) 3 para. 9.

<sup>621</sup> Wood (n 1) 663 – 664.

<sup>622</sup> The US tried to justify this by stating that this would therefore not compromise the international playing field, given that internationally-active banks would still be subject to the rules set out by the Basel regime. See: Ferguson RMA Conference (367). See also: Ferguson IIB Remarks (n 367).

<sup>623</sup> Matt Schlickemaier, *Basel III and Credit Risk Measurement: Variations Among G20 Countries* (San Diego International Law Journal, Vol. 14, University of San Diego School of Law, 2012) 221 – 223. The *Standardized approach* and the *IRB approach* are further described in Chapter 7.

<sup>624</sup> Masera (n 370) 388; US Regulatory Consistency Assessment (n 364) 10; Scott (n 403) 767.

having stated “[w]e are not implementing the Basel agreement, as anyone who will look at this text will be able to tell you”<sup>625</sup>.

Consequently, regulatory arbitrage is encouraged as states adopt their own variations of the Basel Accords, thereby allowing the industry to come up with methods in order to make use of the less restrictive provisions of different jurisdictions, thereby seeking to reduce the costs and limitations which would have otherwise been imposed upon them.

## ***5.4 Regulatory Arbitrage and Shadow Banking***

As shown in Chapter 3, “*shadow banking*” has been intrinsically linked with activities taking place outside of the regulated sector, with this also being the main defining factor as to what constitutes a “*shadow bank*”.

Specific comments on shadow banks and their relationship with the Basel Accords also need to be made, given that the activities which would typically have been provided by banks can be provided through shadow banks, with the latter, however, not being subject to the Basel Accords<sup>626</sup>. This has been described as the “*boundary problem*” – as effective regulation is put in place, firms have an incentive to move their activities outside the “*boundary of regulation*” onto unregulated entities, such as hedge funds, through which they may still carry out their business activities whilst avoiding the prescriptive nature and the costs associated with regulation (with it also having been argued that if regulated entities do not seek to avoid the constraints placed upon them, then probably the regulation imposed is simply ineffective!)<sup>627</sup>. Jacobs and van Vuuren have also noted that though resorting to regulatory arbitrage particularly during the financial crisis was “*reckless and perhaps even unethical, they were in most cases compliant with the letter of the law*”<sup>628</sup>.

Heremans and Paces have noted how stricter capital requirements result in foregone earnings which arise as a result of high capital requirements and in light of the need to regain higher cash reserves, such that such foregone earnings can be considered as a

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<sup>625</sup> Howarth and Quaglia (n 618) 336.

<sup>626</sup> Riles (n 46) 83; Black (n 180) 1040.

<sup>627</sup> Markus Brunnermeier and others, *The Fundamental Principles of Financial Regulation* (International Center for Monetary and Banking Studies, Preliminary Conference Draft, Geneva Report on the World Economy 11, 6 January 2009) 26, 61, 64, 67 <<http://chifl.shufe.edu.cn/upload/htmleditor/File/120504104008.pdf>> accessed 10 January 2015.

<sup>628</sup> Jacobs and van Vuuren (n 600) 319.

“tax” on financial institutions<sup>629</sup>. Therefore, increasing the intermediation cost which financing entities are subject to, leads to disintermediation as larger market shares are transferred to non-regulated entities, giving rise to the problem of regulatory arbitrage<sup>630</sup>. Thus, financial institutions “are bound to respond to an increasing regulatory burden by changing their activities and by introducing financial innovations in an attempt to circumvent the regulatory restrictions”<sup>631</sup>.

Shadow banks generally provide (either acting alone or in a “chain” with other entities) the same type of credit intermediation and maturity transformation as traditional banks, including funding long-term projects through short-term funding, without, however, being subject to the same regulatory constraints as banks, with this also meaning that shadow banks are not required to internalise the true cost of their risks (contrary to banks which are subject to the Basel Accords)<sup>632</sup>. Shadow banks do not fall within the traditional definition of a “bank” since rather than being funded through deposits and other repayable funds, they rely on money market instruments such as mutual funds, short-term commercial paper and repos<sup>633</sup>. Credit intermediation through non-banks has been able to grow over the past years particularly in light of the advantages which these offered, such as providing market participants as well as corporations with alternative sources of funding, as well as in certain instances being able to develop specialised expertise such that certain functions in the credit intermediation function could be carried out more cost-effectively<sup>634</sup>.

Banks are also encouraged to sponsor shadow banks and move their assets off their balance sheets since this would avoid banks having to increase their capital buffers, whilst allowing these sponsoring banks to benefit from unrestricted leverage, particularly since capital requirements are calculated on the basis of a bank’s balance sheet<sup>635</sup>. The FSB has therefore noted, on discussing “shadow banks” in 2011, that “this is

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<sup>629</sup> Heremans and Paccès (n 330) 31.

<sup>630</sup> *ibid.*

<sup>631</sup> *ibid.*

<sup>632</sup> Thomas Rixen, ‘Chapter Five: Offshore Financial Centres, Shadow Banking and Jurisdictional Competition: Incrementalism and Feeble Re-regulation’ in M. Moschella and E. Tsingou (eds), *Great Expectations, Slow Transformations: Incremental Change in Post-Crisis Regulation* (ECPR Press, 2013) 99 – 100; FSB April 2011 (n 310) 5; FSB October 2011 (n 310) 1, 12; FSB August 2013 (n 310) iv; International Monetary Fund (n 328); European Banking Authority (n 328) 5.

<sup>633</sup> Rixen (n 632) 100; FSB April 2011 (n 310) 3; FSB October 2011 (n 310) 1.

<sup>634</sup> FSB October 2011 (n 310) 1; International Monetary Fund (n 328) 37:00 – 39:00.

<sup>635</sup> Rixen (n 632) 100; FSB April 2011 (n 310) 5; The European Banking Authority has consulted on the possibility of limiting exposures to shadow banking entities in accordance with Article 395(2) of the CRR: See: European Banking Authority, *Consultation Paper: Draft EBA Guidelines*

*likely to create opportunities for arbitrage that might undermine bank regulation and lead to a build-up of additional leverage and risks in the system” and that “[a]lthough Basel III closes a number of identified shortcomings, both the incentives for, and the risks associated with, regulatory arbitrage will likely increase as Basel III raises the rigour of bank regulation”<sup>636</sup>. Paccès, however points out that “regulation should not incentivize marketing of financial assets as a way to reduce the burden of capital adequacy (or of any other regulation serving the same purpose)”<sup>637</sup>.*

It has been argued that shadow banks may be as systemically important as banks, notwithstanding that they do not accept deposits from the public, since the main concern for the liquidity and stability of the financial system is whether these entities carry out maturity transformation or otherwise<sup>638</sup>. Entities which rely on short-term (liquid) liabilities to finance long-term (illiquid) securities or projects become relevant for the liquidity and the stability of the financial system as a whole<sup>639</sup>. Thus shadow banks also give rise to various systemic risk considerations since they are strongly interconnected with banks and the banking system, as banks sponsor shadow banks, use shadow banks for regulatory arbitrage purposes, and whilst shadow banks and alternative financing entities also resort to banks for liquidity purposes (particularly in the short term)<sup>640</sup>.

The FSB has noted how banks and shadow banks can easily become interlinked, such that risks arising in shadow banks necessarily cause spillover effects onto banks and regulated entities<sup>641</sup>. Frequently banks also form part of a chain of entities through which shadow banks provide credit intermediation functions<sup>642</sup>. Furthermore banks may also be exposed to shadow banks through temporary exposures, through the

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*on Limits on Exposures to Shadow Banking Entities Which Carry Out Banking Activities Outside a Regulated Framework Under Article 395 para. 2 Regulation (EU) No. 575/2013 (EBA/CP/2015/06, 19 March 2015)*  
<http://www.eba.europa.eu/documents/10180/1019894/EBA+CP+2015+06+%28CP+on+GL+on+shadow+Banking%29.pdf> accessed 30 April 2015, and this has been followed up by Guidelines which are to take effect as from 1 January 2017 (see European Banking Authority (n 328)); Brunnermeier and others (n 627) 11, 61, 67.

<sup>636</sup> FSB April 2011 (n 310) 5; FSB October 2011 (n 310) 12.

<sup>637</sup> Alessio M Paccès, *Law and Economics of the Financial Crisis: Rethinking Market and Regulatory Failures in a World of Uncertainty* (European Association of Labour Economists Annual Conference 2009) 14  
<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.573.6188&rep=rep1&type=pdf> accessed 24 January 2016.

<sup>638</sup> Heremans and Paccès (n 330) 16.

<sup>639</sup> *ibid.*

<sup>640</sup> *ibid* 27 – 28.

<sup>641</sup> FSB October 2011 (n 310) 1 – 3; FSB October 2014 (n 310) 24.

<sup>642</sup> FSB October 2011 (n 310) 3; FSB October 2014 (n 310) 24.

provision of finance, or through the provision of contingent credit lines<sup>643</sup>. Banks may be funded by entities forming part of the shadow banking system (such as money market funds), and banks and shadow banks may also be exposed to a number of common counterparties particularly since they may invest in similar assets<sup>644</sup>. Therefore stress in one of these sectors can easily be transmitted to the other sector leading to possible contagion<sup>645</sup>.

In this context, Canova has highlighted the dangers of not extending capital requirements to hedge funds, particularly in light of the vast amount of funds being controlled by the said “*unregulated hedge funds*”<sup>646</sup>, and the “*destabilizing ripple effects throughout the financial markets*” that the failure of any such large hedge fund may have<sup>647</sup>. Canova however notes that “*it is uncertain whether Congress and the president can muster the political will to impose regulation on such private centers of wealth, privilege, and power, which cross national borders*”<sup>648</sup>.

It has been noted that credit intermediation and the linkages between different credit intermediaries may, of their nature, have the potential of causing systemic risks with this being the main cause of concern arising from the use of hedge funds and shadow banks<sup>649</sup>. Whereas when corporates and other entities become insolvent they tend to strengthen their competitors (as a competitor is removed from the market), when a credit intermediary fails, this weakens other credit intermediaries as one of the links in the chain of credit intermediation is dislodged<sup>650</sup>. This can also be seen from the potential systemic repercussions which became very evident on the failure of the American hedge fund Long-Term Capital Management in 1998<sup>651</sup>. Thus whilst shadow banks can be the subject of “*runs*”, the leverage they use can also increase procyclicality, with the interconnectedness with the banking system providing further potential

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<sup>643</sup> *ibid.*

<sup>644</sup> *ibid.*

<sup>645</sup> FSB October 2014 (n 310) 24.

<sup>646</sup> Riles (2014) has noted how the shadow banking sector tripled in size since the 2008 global financial crisis, whilst Howarth and Quaglia also explain how global assets managed by hedge funds grew 50-fold between 1990 and 2007. See: Riles (n 46) 65; Howarth and Quaglia (n 309) 113; See also: Rixen (n 632) 100.

<sup>647</sup> Canova (n 171) 395 – 396.

<sup>648</sup> *ibid* 396.

<sup>649</sup> Steven L Schwarcz, *Systemic Risk* (The Georgetown Law Journal, Vol 97, 2008) 202.

<sup>650</sup> Brunnermeier and others (n 627) 3; Schwarcz (n 649) 202.

<sup>651</sup> Howarth and Quaglia (n 309) 113; Schwarcz (n 649) 195, 201.

systemic risks in that the failure of a shadow bank can have ripple effects on the financial system as a whole<sup>652</sup>.

The FSB has also noted that in light of the short-term financing used by shadow banking, they may be subject to “runs” which may cause systemic concerns<sup>653</sup>. As bank financing becomes less attractive and industries move towards alternative methods of financing in order to raise funds, one simply finds an element of risk-shifting onto these alternative methods of financing, rather than there being a wholesome solution to a problem. Though the FSB has highlighted the need for regulation, particularly in order to avoid regulatory arbitrage through the use of shadow banks, regulation which seeks to eliminate the transfer of risk from the regulated to the unregulated sector through regulatory arbitrage continues to be lacking<sup>654</sup>.

The end result therefore is that rather than reducing risks in financial activities, these risks are only being transferred to other less regulated providers of finance which may replace traditional banks in their traditional activities of financial intermediation and be subject to the same risks and problems which banks faced before the development of the Basel Accords. This lack of regulatory convergence may very well result in there being a lack of soundness and stability in the system as a whole, with potentially alternative methods of financing giving rise to those systemic risks which banks are being protected from. This may also negatively affect long term financing in the long run as alternative methods of financing may not necessarily be geared towards providing long term financing towards certain industries in the same way as banks, given that certain shadow banks, such as hedge funds, may be more focused on short term and medium term gains, and may seek to exit from certain projects once good opportunities to liquidate certain financings become available.

Engert has recognised that states compete for hedge fund business through regulatory competition (by offering “*less costly regulation or no (direct) regulation at all*”), with this

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<sup>652</sup> FSB April 2011 (n 310) 4; European Banking Authority (n 635) 7; FSB October 2011 (n 310) 1; FSB August 2013 (n 310) iv; European Banking Authority (n 328) 5, 6.

<sup>653</sup> FSB April 2011 (n 310) 4; FSB October 2011 (n 310) 1 – 3.

<sup>654</sup> The FSB has, *inter alia*, proposed that consolidation rules should apply between banks and shadow banks such that bank sponsors do not benefit from having off-balance sheet items in light of shadow banking activities they carry out; further limit bank exposures to shadow banking entities; that the risk-based capital requirements for banks’ capital exposures to shadow banking entities be reviewed to ensure that such risks are adequately captured; and restrict banks’ ability to stand behind entities that are not consolidated with the said bank; FSB October 2011 (n 310) 16 - 26; See also: FSB April 2011 (n 310).

in turn working against states' objectives of curbing systemic risks<sup>655</sup>. Rixen argues that whilst states engage in regulatory competition in order to seek to attract financial activity (with this possibly resulting in a race to the bottom amongst states) it is not possible for large states to rely solely on the financial activity attracted by these incentives, and large states should preferably act collectively in order to seek to curb regulatory competition (since a single jurisdiction acting alone would not be able to do so)<sup>656</sup>. However even here, Rixen notes that those states with larger financial sectors (such as the US and the UK) have more to lose than others by acting collectively and these jurisdictions would therefore be more hesitant to support harmonised collective action<sup>657</sup>.

Engert argues that regulatory arbitrage can only be managed through the emergence of a "cartel" in regulation whereby different states coordinate their actions towards regulatory harmonisation, whilst exerting pressures on other states in order to eliminate regulatory arbitrage opportunities through shadow banking activities<sup>658</sup>. This is essential for the development of any form of harmonised rules and regulations in light of the number of shadow banks established in offshore financial jurisdictions<sup>659</sup>. This is also true in light of Rixen's assertion that "[a]s long as nation states conceive themselves to be in a position of jurisdictional competition, they do not have any interest in real change"<sup>660</sup>. The varying interests of different jurisdictions have led to very limited action on regulation<sup>661</sup>.

This has however also proven difficult at EU level, with different states having different approaches towards shadow banking, with jurisdictions with many hedge fund managers, such as the UK, being much more cautious about the potential influence of EU regulation in this area and the potential loss of business to alternative, less-regulated jurisdictions<sup>662</sup>. The regulation (or lack of it) at EU level has therefore been a continuous source of tension between those favouring regulation and those opposing it – with the

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<sup>655</sup> Engert (n 308) 332.

<sup>656</sup> Rixen (n 632) 104 – 105.

<sup>657</sup> *ibid* 105.

<sup>658</sup> Engert (n 308) 332, 362.

<sup>659</sup> Rixen (n 632) 101; Nevertheless the introduction of third-party equivalence by the European Union on the introduction of the AIFMD can also be seen as a first step in this direction: See: Howarth and Quaglia (n 309) 121 – 125.

<sup>660</sup> Rixen (n 632) 118.

<sup>661</sup> See: Howarth and Quaglia (n 309) 116 – 118.

<sup>662</sup> Howarth and Quaglia (n 309) 114, 118 – 120.



balance only having tipped in favour of regulation following the financial crisis<sup>663</sup>. Nevertheless, even here, it has been stated (on considering the negotiations leading up to the AIFMD and the draft directive which was being discussed prior to the adoption of the AIFMD) that<sup>664</sup>:

*[t]he draft directive was revised following intense lobbying from affected financial service firms [...] and the American and British governments. In the end, the most controversial proposals, including plans to impose fixed caps on leverage and capital requirements, were either removed or significantly watered down.*

Though the AIFMD formalised certain business practices in the hedge fund management industry (such as requiring hedge fund managers to appoint a separate custodian) and necessitated certain reporting requirements, the business practices were not affected in any significant manner<sup>665</sup>. Specifically from a capital requirements' point of view, the AIFMD established minimum initial capital requirements for AIFMs, whilst only establishing capital requirements in order to establish a requirement of holding minimum own funds being "*equivalent to one quarter of their preceding year's fixed overheads*"<sup>666</sup>. The AIFMD has adopted the same approach of the Dodd-Frank Act, which requires hedge funds of a certain size to be registered with the Securities and Exchange Commission ("**SEC**"), whilst imposing reporting requirements and making hedge funds subject to periodic inspections by the said regulator<sup>667</sup>.

In light of the above the FSB has been working towards establishing regulation in order to deal with shadow banks, with particular emphasis being given to the following areas<sup>668</sup>:

- (i) mitigating risks in banks' interactions with shadow banking entities;*
- (ii) reducing the susceptibility of money market funds (MMFs) to "runs";*
- (iii) improving transparency and aligning incentives in securitization;*
- (iv) dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and*

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<sup>663</sup> *ibid* 119.

<sup>664</sup> *ibid* 119 – 120.

<sup>665</sup> *ibid* 120.

<sup>666</sup> See: AIFMD (n 306) art 9.

<sup>667</sup> Howarth and Quaglia (n 309) 120.

<sup>668</sup> FSB August 2013 (n 310) 1.

- (v) *assessing and mitigating financial stability risks posed by other shadow banking entities and activities.*

The BCBS has since sought to adopt the FSB's suggestions in applying capital requirements and applying leverage adjustments for banks' equity investments in funds<sup>669</sup>. The BCBS has therefore set out three different approaches through which banks' equity investments in funds contribute towards banks' capital requirements. In the "*look-through approach*" the bank is to apply risk weights to a fund's underlying exposures "*as if the exposures were held directly by the bank*"<sup>670</sup>. In the "*mandate-based approach*" banks assign "*risk weights on the basis of the information contained in a fund's mandate or in the relevant national legislation*"<sup>671</sup>. On the other hand in the "*fall-back approach*" a 1,250% risk weight is applied to a bank's equity investment in a fund<sup>672</sup>. A leverage adjustment is also applied to the average risk weight of the fund by its leverage for a given equity investment, with this being subject to a cap of 1,250%<sup>673</sup>. It is however unclear as to why the BCBS has limited the focus of such bank exposures to shadow banking entities to "*equity investments*" rather than referring to all exposures (including debt) which banks have with shadow banking entities<sup>674</sup>.

It is therefore being submitted that the above focal points established by the FSB in dealing with shadow banks are intrinsically contradictory. Whilst the FSB argues that banks' interactions with shadow banking entities need to be regulated in order to mitigate the risks which banks are subject to, the above proposals do not apply the same

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<sup>669</sup> See: Basel Committee on Banking Supervision, *Capital Requirements for Banks' Equity Investments in Funds* (Basel Committee on Banking Supervision, December 2013) <<http://www.bis.org/publ/bcbs266.pdf>> accessed 23 December 2015.

<sup>670</sup> Basel Committee on Banking Supervision (n 669) 2, 3.

<sup>671</sup> *ibid* 2 – 4.

<sup>672</sup> *ibid* 2, 4.

<sup>673</sup> *ibid* 2, 5.

<sup>674</sup> The approach taken by the European Banking Authority has been wider as it refers to all exposures which institutions have to shadow banking entities. The European Banking Authority will be requiring (as from 1 January 2017) the application of either of two approaches by institutions with exposures to shadow banking entities. The first approach referred to is the "*principal approach*" whereby institutions set individual limits on exposures to shadow banking entities depending on, *inter alia*, the particular nature of the shadow bank to which it is exposed, the financial situation of such shadow bank, information and evidence available on the portfolio of the shadow bank, on the asset price or credit quality volatility of the shadow banking entity; and the interconnectedness of such entity with the particular institution. The second approach is the "*fallback approach*" where institutions which cannot meet the requirements of the principal approach are required to apply the limits on large exposures to the sum of the exposures to shadow banking entities to which the principal approach cannot be applied. See: European Banking Authority (n 328).

risk mitigation techniques to which banks are subject (i.e. through the Basel Accords generally), to shadow banks. It is clear that regulators are wary of the consequences which may arise on there being the failure or insolvency of a shadow bank such that they want to ensure that particular types of “*shadow banks*” are not subject to “*runs*”<sup>675</sup>. Nevertheless the principles which apply to banks (and investment firms in the EU and other jurisdictions) are not similarly applied to shadow banks and therefore banks are still encouraged to shift their business from the regulated sector to the unregulated (or regulation-lite sector) through the use of shadow banks, and these shadow banks are not tasked with ensuring that certain capital and liquidity requirements continue to be in place notwithstanding the similarity in their activities to the activities which banks undertake. The proposed scope of regulation therefore seems to ignore the possibility of there being the failure of shadow banks (other than through there being a “*run*”).

It is submitted that wide differences still continue to exist and that different rules and regulations still continue to apply to different entities – notwithstanding the economic function which they undertake, even though the FSB has stated that<sup>676</sup>:

*[b]y focusing on the economic function (or activities) rather than the legal forms of entities conducting them, the recommendations are intended to be robust in the face of innovations and adaptations that occur at or outside the boundaries of bank regulation or the regulatory perimeter.*

In order for this distinction to be abolished and in order to eliminate regulatory arbitrage opportunities, those entities which carry out the same economic functions (whether under the name of “*banks*”, “*investment firms*”, or other forms of financing vehicles such as “*AIFs*” or “*shadow banks*”) need to be subject to the same regulations – in the absence of which there will continue to be incentives for those financing activities which give rise to risk to move from the regulated sectors to the unregulated sectors<sup>677</sup>.

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<sup>675</sup> FSB August 2013 (n 310) 3.

<sup>676</sup> *ibid* 1.

<sup>677</sup> Though as discussed throughout this thesis even if the Basel Accords were to apply to all banks, investment firms and to shadow banks equally, inconsistencies would still arise in light of varying approaches taken by national regulators and also due to differences arising in underlying national laws (and particularly in light of differences in the level of risk depending on whether a jurisdiction can be considered to be pro-debtor or pro-creditor).

Contradictions can also be clearly seen from the EBA Guidelines which seek to limit exposures to shadow banking entities<sup>678</sup>. After considering the microprudential risks which shadow banks may give rise to, it stated as follows<sup>679</sup>:

*Macro prudentially, institutions' exposures to shadow banking entities could be of concern for different reasons. Here, institutions' exposures to such entities undertaking bank-like activity may lead to regulatory arbitrage concerns, and worries that core banking activity may migrate systematically from the regulated sector 'into the shadows'. In order to seek profits, institutions may still actively seek ways to arbitrage rules by funding shadow banking entities. These entities, which are potentially more vulnerable to runs and/ or liquidity problems, tend to be highly correlated and interconnected with the banking sector, which leads to financial stability concerns.*

However, whilst the regulatory arbitrage potential is clearly outlined in the EBA Guidelines, and the risks which shadow banks give rise to are also recognised, the regulations and guidelines do not consider equating regulation of “shadow banks” with that of “investment firms” or of “banks” in the EU. Regulation therefore only seeks to ensure that banks continue to be protected by setting limits on the exposures which banks have to shadow banking entities. The EBA Guidelines therefore continue by stating<sup>680</sup>:

*To minimise the risks posed to institutions arising from their exposures to shadow banking entities, the guidelines lay down requirements for institutions to set limits, as part of their internal processes, on their individual exposures to shadow banking entities (alleviating primarily the microprudential concerns expressed above) and on their aggregate exposure to shadow banking entities (alleviating macroprudential concerns.*

Thus, the potential macroeconomic consequences of the failure of (or of runs on) shadow banks is ignored notwithstanding the substantial economic role which these entities play and the potential negative consequences on financial stability which may arise from a shadow bank facing financial or liquidity difficulties.

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<sup>678</sup> European Banking Authority (n 328).

<sup>679</sup> *ibid* 3, 12.

<sup>680</sup> *ibid*.

## 5.5 Conclusion

Part III of this thesis has started off by considering the entities to which the Basel Accords apply in different jurisdictions. It has been shown how there are severe variances across different jurisdictions, such that though the Basel Accords had been established for the sole purpose of applying to “*internationally-active banks*”, these today apply to different types of entities across different jurisdictions.

It has also been shown how though the Basel Accords had “*regulatory convergence*” as their initial objective, this changed along the years in order to shift towards there being reduction of “*systemic risks*”. This Part III also argues that differences in regulation are giving rise to regulatory arbitrage, with this encouraging a shift in financial activity from the regulated sectors to the unregulated sectors through the use of shadow banks and other entities which are not subject to the Basel Accords across different jurisdictions.

It is here argued that the drafters of the Basel Accords have failed to adopt a law and economics approach, and consequently the BCBS failed to consider the interests of the different actors identified in Section 2.3. Thus, as each of these actors seeks to maximise his utility, the effectiveness of the Basel Accords becomes much more limited, with the Basel Accords losing their legitimacy and accountability even further.

This thesis therefore argues that since regulatory competition still exists, a proper framework should be established wherein regulatory competition is recognised and properly regulated. This thesis therefore argues that the main concepts which underlie the Basel Accords should be agreed to in a binding treaty, giving rise to legal rights and obligations between different states. This should set out the limits to regulatory competition in order to avoid a race to the bottom. On the other hand, however, such a system will result in individual nation states taking responsibility for their actions, and thereby limiting the loopholes they seek to create on seeking to attract further players. States should therefore work with the industry in order to ensure that entities which carry out the same economic function (such as banks, and shadow banks) are subject to the same laws, and different laws and different entities across different jurisdictions are not made use of in order to arbitrage the system and reduce the effectiveness of the Basel Accords. It is therefore argued that national regulatory agencies and individual states know the relevant players within their market in a much better way than a transnational regulatory network does, and national regulatory agencies should therefore be given flexibility and incentives to ensure the effectiveness of the Basel

Accords, rather than have incentives to seek ways and means whereby they encourage the industry to arbitrage the regulatory system.

Part IV of this thesis will continue by arguing that though the Basel Accords seek to create a transnational regulatory law which reduces systemic risks, the Basel Accords seemingly start off from the presumption that risk does not vary from one jurisdiction to another and does not depend on the underlying legal framework in each jurisdiction. This thesis however argues that the Basel Accords remain subject to domestic embeddedness such that the same transnational regulatory law will have different effects in different jurisdictions, with this being dependent upon the underlying laws within which the Basel Accords are to apply. The main distinctions which will be drawn relate to the different laws on insolvency and on security interests across different jurisdictions, such that it will be argued that financing entities which operate in pro-debtor jurisdictions are subject to much more risks than financing entities which operate in pro-creditor jurisdictions, notwithstanding that the Basel Accords do not give any importance to these differences.

## **PART IV – THE PROBLEM OF DOMESTIC EMBEDDEDNESS**

## Chapter 6: Domestic Embeddedness and Differences Arising from Underlying National Laws

Whilst Part III of this thesis argued that the Basel Accords did not consider the Basel Accords from an economics perspective, and with this giving rise to regulatory arbitrage, Part IV focuses on another main limitation of the Basel Accords, by arguing that the Basel Accords do not distinguish between the different legal systems within which they operate. It is here contended that even if the Basel Accords were to be adopted in a perfectly uniform manner in different jurisdictions, and even if each different national regulator were to work towards there being regulatory convergence and the reduction of systemic risks, the fact that the Basel Accords need to operate within different national frameworks still means that the Basel Accords will give rise to different outcomes in different jurisdictions. Divergences will occur as a result of intrinsic differences which exist within underlying national laws<sup>681</sup>. Furthermore one can also argue that unless the transnational regulatory laws resonate with local laws, then issues of legitimacy will also arise for this reason<sup>682</sup>.

The main function of the Basel Accords is that of seeking to minimise and regulate risks which internationally-active banks face. Capital adequacy is therefore required to be respected by internationally-active banks in order for this to act as a buffer against losses which banks may incur whilst catering for potential runs which they may face due to a general drop in the confidence in the banking industry. Given that the Basel Accords regulate risk, the underlying assumption arising from the Basel Accords (as a transnational regulatory law) is that entities operating in different states, are subject to the same risks, notwithstanding the underlying domestic laws and legal culture within which they operate.

It is here argued that the most fundamental differences amongst different jurisdictions, and which particularly affect the variances which arise between one jurisdiction and another in regulating risk, are the national laws which relate to insolvency and to security interests. The laws on security interests (and other “*credit risk mitigation*

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<sup>681</sup> Though the BCBS publishes “progress reports” which seek to provide indicators as to the status of implementation of the Basel Accords, it ignores the fact that the same transnational regulatory law is bound to have different effects in different jurisdictions in light of the varying national laws within which the Basel Accords are to operate. See: Basel Committee on Banking Supervision (n 529).

<sup>682</sup> Shaffer (n 201) 256.



*techniques*”, which also include the possibility of netting and set-off on insolvency, the provision of guarantees and the availability of the trust) allow banks and financing parties to get recourse to funds owed to them on there being a debtor in default. Furthermore, the laws on insolvency and the policy choices made in relation thereto affect the relationship a creditor may have with a debtor, and the relationship a secured creditor may have with other unsecured creditors of a debtor who would be in default.

This Chapter will set out by considering the main differences arising from national laws in relation to insolvency, as well as in relation to the ways in which creditors seek to reduce their risks (referred to in the Basel Accords as “*credit risk mitigants*”, but which generally refers to the strength and availability of security interests). It will also show that there has been little harmonisation of these laws across different jurisdictions. Chapter 7 will then take a closer look at different types of credit-risk mitigation techniques and how these are dealt with by the Basel Accords.

### ***6.1 Pro-Debtor and Pro-Creditor Jurisdictions: Differences in Laws on Insolvency and Security Interests***

The features of insolvency law and the strength of security interests in a particular jurisdiction affects the confidence which a creditor may have and the ease of provision of credit by a financing party to a party in need of finance. This Chapter will show that notwithstanding there being one transnational regulatory law regulating capital adequacy (the Basel Accords), this operates within very different underlying frameworks, meaning that banks and financing entities (as creditors of customers to which they would have provided finance) are subject to varying levels of risk, arising from the specific legal system within which they operate and the underlying national laws.

Wood has considered insolvency law to be the “*root*” of commercial and financial law on stating<sup>683</sup>:

*Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go around and so the law must choose who to pay. The choice cannot be avoided or compromised or fudged. The law must always decide who is to bear the risk so that there is a winner and a loser. On bankruptcy it is difficult to split the difference. That is why bankruptcy is the most*

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<sup>683</sup> Wood 1995(I) (n 15) 94.

*crucial indicator of the attitudes of a legal system and arguably the most important of all commercial legal disciplines.*

He has also stated<sup>684</sup>:

*... it is only on insolvency that jurisdictions are forced to make the most difficult choice between winner and the loser, a choice which can otherwise often be fudged or compromised. In addition, it is insolvency that leads to real competition and arouses the deepest resentment and the greatest losses.*

As will be seen below, different jurisdictions adopt different policy choices and choose whether to increase efficiency for the benefit of a creditor, or alternatively whether the need to protect and safeguard debtors' interests is given priority.

The role of security interests (and other credit risk mitigation techniques generally) is important in that it allows secured parties to have recourse over particular assets or against particular persons in order to safeguard such secured parties' interests, and this therefore provides an *ex-ante* perspective to insolvency. Insolvency laws, on the other hand, regulate the relationship between creditors and their debtors, and also between the various creditors amongst themselves on a debtor being declared insolvent. Insolvency law therefore provides an *ex-post* perspective, whereby the relationship between different parties is considered on an insolvency event having occurred.

Cohen has examined the links between "*security interests*" and "*international insolvency law*" and has come to the conclusion that there are various legal and economic links between the two<sup>685</sup>. He has considered that as "*rights created under the aegis of secured credit law are sometimes vulnerable in bankruptcy; for this reason, bankruptcy law is often considered the "acid test" of any security interest*"<sup>686</sup>. Similarly Buxbaum has noted that<sup>687</sup>:

*When a debtor enters insolvency, applicable bankruptcy or insolvency law may interfere in a variety of ways with security rights. In many systems, the bankruptcy petition suspends the ability of a secured creditor to enforce its interest against the debtor; in addition, the bankruptcy administrator in most regimes has the power to*

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<sup>684</sup> Wood 2007 (n 15) 335.

<sup>685</sup> Neil B Cohen, *Harmonizing the Law Governing Secured Credit: The Next Frontier* (Texas International Law Journal, Vol. 33, 1998) 174.

<sup>686</sup> *ibid.*

<sup>687</sup> Hannah L Buxbaum, *Unification of the Law Governing Secured Transactions: Progress and Prospects for Reform* (Uniform Law Review, Vol 8, 2003-1/2, UNIDROIT, 2003) 325.

*avoid as preferential transfers some types of security rights created in the immediate pre-petition period.*

One important caveat is that this Chapter will not be dealing with procedural issues of insolvency but will mainly focus on substantive issues. It will primarily consider general principles applicable to corporations (given their major impact on economies, and hence risks to financing entities), and will therefore not analyse bankruptcy regimes of individuals and family companies or partnerships which may be different from those applicable to corporations.

As different laws seek to protect different parties, this gives rise to different risks to financial entities, depending on which jurisdictions they operate in. Distinctions will be drawn between pro-creditor jurisdictions and pro-debtor jurisdictions and it will be argued that financing entities operating in pro-creditor jurisdictions are consequently subject to less risk than those financing entities which operate in pro-debtor jurisdictions. This thesis will therefore argue that the one-size-fits-all approach adopted by the Basel Accords in relation to different jurisdictions (notwithstanding that these may be pro-debtor or pro-creditor jurisdictions) is not appropriate. The differences in the laws of different states within which the Basel Accords are to operate lead to different risks which the Basel Accords do not cater for, resulting in their being a situation whereby though similar regulatory laws may apply amongst different jurisdictions, the actual risks which banks and other financing entities face varies depending on the underlying laws within which they operate. Thus, regulation does not adequately price risks according to the risks emanating from the underlying laws of particular jurisdictions, but simply assumes that having one transnational regulatory law would give rise to similar results as if the said transnational regulatory laws operate in a completely harmonised framework.

Notwithstanding the different risks which pro-creditor and pro-debtor jurisdictions are subject to, and despite credit risk mitigants which different jurisdictions may adopt, the Basel Accords (and other implementing laws such as the CRR and the CRD IV), which establish various risk provisions in order to ensure the safety of banks, do not consider the underlying position of creditors in the said underlying laws. Though the Basel Accords do consider the importance of credit risk mitigants, they only do so limitedly (and generally only in relation to financial collateral, as will be seen in Chapter 7).

The presumption in the Basel Accords is that as long as the required ratios are complied with, the subjects of those rules will be safe – and this without consideration of the risks

arising from the underlying laws of different states. The Basel Accords therefore do not distinguish between pro-debtor states and pro-creditor states, and the ease through which creditors can deal with insolvent entities. Similarly, the strength of security interests (and other credit risk mitigants) in different states is also ignored, notwithstanding that this may affect the ease through which a financial entity can have access to collateral which would be used as security in favour of such financing entity. Unfortunately, however this also means that given the limited scope of eligible financial collateral, banks and financial entities which are subject to the Basel Accords are disadvantaged against the financing entities to which the Basel Accords do not apply, particularly since the credit risk mitigants they put in place may not be given due consideration by the applicable regulatory laws.

### 6.1.1 Pro-Creditor and Pro-Debtor Systems

Wood has noted that the world's legal systems have historically been divided into three main groups which had "*a very different idea about who to pay on bankruptcy*"<sup>688</sup>. These three different groups were the Napoleonic systems (which protected debtors); English Common Law systems (which protected creditors); and Roman-Germanic systems (which were somewhere "*in between*" the Napoleonic systems and the English Common Law systems)<sup>689</sup>. He has however noted that this threefold polarization is merely historical and is inconsistent with the present day culture of the relevant jurisdictions<sup>690</sup>.

Wood has further classified present-day jurisdictions into three categories (which still continue to be similar to the historical classification)<sup>691</sup>. This threefold classification consists of "*pro-creditor*" jurisdictions; "*pro-debtor*" jurisdictions; and those jurisdictions which Wood considers as being "*not interested*" (and which in his view consist of certain Communist states, certain fundamentalist Muslim states and those states without a commercial tradition)<sup>692</sup>. He also considers that there are a few jurisdictions which may then be classified as "*don't knows*"<sup>693</sup>.

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<sup>688</sup> Wood 2008 (n 15) 242; Robert R Bliss, *Bankruptcy Law and Large Complex Financial Organizations: A Primer* (Economic Perspectives, First Quarter, 2003) 50 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=378320](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=378320)> accessed 26 March 2015.

<sup>689</sup> *ibid* 242.

<sup>690</sup> *ibid*; Wood has split these further into eight different groups, consisting of: American common law jurisdictions; English common law jurisdictions; Napoleonic jurisdictions; Roman-Germanic jurisdictions; Mixed civil/common law jurisdictions; Islamic jurisdictions; New jurisdictions; and unallocated jurisdictions; See: Wood 2007 (n 15) 333.

<sup>691</sup> Wood 1995(I) (n 15) 96.

<sup>692</sup> *ibid*; Bliss (n 688) 50.

<sup>693</sup> Wood 1995(I) (n 15) 96.

It has been noted that the main difference between pro-debtor jurisdictions and pro-creditor jurisdictions is that whereas pro-creditor jurisdictions allow creditors to be pro-active and seek to protect themselves from the limitations which would otherwise apply in insolvency (such as through the obtainment of certain security interests, or through the possibility of setting-off claims on insolvency), in pro-debtor jurisdictions the main interest of the law is to maximise the value of the assets of the insolvent entity for the benefit of an insolvent debtor<sup>694</sup>.

The main argument in favour of pro-creditor states is that creditors should be able to avoid losses arising from the default of a debtor, and that the impossibility of having such a system in place will lead to risks to all and possibly even risks to the financial system as a whole<sup>695</sup>. It has been argued that insolvency systems are important in order to resolve financial distress and that strong creditor rights lead to both efficient *ex-post* resolution of distressed corporations, whilst also affecting *ex-ante* risk taking incentives<sup>696</sup>. Efficient systems of insolvency make it easier for firms to get credit and hence encourage investment, particularly since these insolvency laws reassure creditors that they will have recourse to the money due to them in the event of a debtor becoming insolvent<sup>697</sup>. On the other hand it has been argued that if insolvent entities are punished too severely, entrepreneurship may be discouraged as entrepreneurs are put off from taking financial risks in order to carry out their particular economic activities<sup>698</sup>. Therefore both the availability of debt, as well as the willingness for entrepreneurs to take on debt has been considered as an essential element for there to be economic growth<sup>699</sup>.

The aim of pro-debtor laws is to ensure that insolvent entities (and their employees) are safeguarded, and that creditors assist debtors who find themselves close to insolvency, particularly also by granting time through which a debtor's estate can improve, thus also resulting in unsecured creditors being able to benefit from a greater pool of assets<sup>700</sup>. It has however also been argued that though pro-debtor states seek to destroy creditor

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<sup>694</sup> *ibid*; Bliss (n 688) 50.

<sup>695</sup> Wood 1995(I) (n 15) 96.

<sup>696</sup> Marianna Succurro, *Bankruptcy Systems and Economic Performance Across Countries: Some Empirical Evidence* (Università della Calabria, Dipartimento di Economia e Statistica, Working Paper n. 01 – 2008, December 2008) 4 <[http://www.ecostat.unical.it/RePEc/WorkingPapers/WP01\\_2008.pdf](http://www.ecostat.unical.it/RePEc/WorkingPapers/WP01_2008.pdf)> accessed 29 March 2015.

<sup>697</sup> *ibid* 2.

<sup>698</sup> *ibid*.

<sup>699</sup> *ibid*.

<sup>700</sup> Wood 1995(I) (n 15) 96.

and owner rights in order to increase the estate of the insolvent entity, many times this merely results in greater returns to priority creditors (such as the state through taxes, and employees), and that unsecured creditors are rarely better off particularly since the returns on insolvency are generally still very small<sup>701</sup>.

Pro-creditor and pro-debtor systems have at their basis two main irreconcilable principles, and which are both based on the need of “*fairness*”<sup>702</sup>. In pro-creditor systems it has been considered as unfair for there to be “*cherry picking*”, whereby a bankruptcy administrator claims amounts due from a solvent counterparty under one contract, whilst simultaneously refusing to pay that same counterparty under another contract<sup>703</sup>. Therefore “*cherry picking*” is considered to be contrary to the principles on which pro-creditor systems are based, with pro-creditor systems typically allowing for set-off on insolvency, with the right of contracting parties to freely protect themselves against events of default by entering into contractual arrangements, such as through netting agreements and the provision of collateral<sup>704</sup>.

Pro-debtor systems, on the other hand, see *ex ante* private contracting of creditor protection agreements as creating “*a privileged class of claimants to the detriment of the remaining creditors*”<sup>705</sup>. This protection leads to certain creditors being more protected than other creditors if amounts could be netted against an insolvent entity – leading to other creditors suffering more substantial losses<sup>706</sup>. Pro-debtor systems (particularly those having a Civil Law background) see set-off agreements as providing “*unpublicized security*” and therefore certain assets are set aside for the benefit of a particular creditor without other creditors having knowledge of that limitation, with pro-debtor systems therefore considering such arrangements as being unfair to the general body of creditors<sup>707</sup>.

It has thus been stated that there needs to be a careful balance between debtor interests and creditor interests on establishing insolvency regimes, and that in situations where judicial expertise is not effective, where judicial ability is lacking, and where contract

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<sup>701</sup> *ibid* 97.

<sup>702</sup> Bliss (n 688) 50; William J Bergman and others, *Netting, Financial Contracts, and Banks: The Economic Implications* (Federal Reserve Bank of Chicago, WP 2004-02, 2004) 7 <<https://www.chicagofed.org/~media/publications/working-papers/2004/wp2004-02-pdf.pdf>> accessed 26 March 2015.

<sup>703</sup> *ibid*.

<sup>704</sup> *ibid*.

<sup>705</sup> *ibid*.

<sup>706</sup> *ibid*.

<sup>707</sup> *ibid*.

enforcement deteriorates, pro-creditor systems are preferred<sup>708</sup>. Thus in order for certain pro-debtor elements to function properly, such as attempts to preserve going-concern value, as found in the US through the promulgation of Chapter 11 of the US Bankruptcy Code, effective judicial expertise is required, with this being essential in order for there to be proper identification of viable firms<sup>709</sup>. In the absence of this ability, Ayotte and Yun argue that creditor-friendly systems should be preferred<sup>710</sup>.

Whether pro-creditor or pro-debtor policies maximise creditor returns is “*highly controversial*”<sup>711</sup>. Nevertheless some jurisdictions have chosen to prefer credit providers’ (such as banks) interests, instead of debtors’ interests, with the view being put forward that this is essential since banks are the main intermediaries of credit and should be preferred in light of them holding the savings of various individuals<sup>712</sup>. Wood has however also acknowledged that preference towards creditors also developed due to a distaste of debtors who became bankrupt<sup>713</sup>.

An important point for the purpose of this study, however, is that financing entities, as creditors, necessarily favour pro-creditor systems in light of the possibility of ease of enforcing their rights over collateral provided and with the possibility of declaring a default over the debtor, or alternatively by taking control of the entity which would have been financed (or by using these as negotiating tools in their discussions with their defaulting debtors) on there being the need to enforce its rights. Pro-creditor systems therefore result in there being less risk for banks and financing entities on the insolvency of their debtors as they are presented with stronger security interests and easier enforcement mechanisms should there be the need.

Therefore, financiers prefer pro-creditor laws given that lending and financing is less risky as a result of there being sufficient creditor control rights<sup>714</sup>. As will be seen below, however, different risks exist in different jurisdictions and there has been little or no

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<sup>708</sup> See: Kenneth Ayotte and Hayong Yun, *Matching Bankruptcy Laws to Legal Environments* (The Journal of Law, Economics & Organization, Vol. 25 No. 1, OUP, 2007) <<http://jleo.oxfordjournals.org/content/25/1/2.full.pdf+html?hwshib2=authn%3A1447188888%3A20151109%253A1a621f6d-a137-4959-8445-0702e7ecea4d%3A0%3A0%3A0%3A8aL0KOBNOdypBQS2dlhBDg%3D%3D>> accessed 10 April 2015.

<sup>709</sup> Ayotte and Yun (n 708) 2, 4, 25.

<sup>710</sup> *ibid* 4, 25.

<sup>711</sup> Wood 2007 (n 15) 337.

<sup>712</sup> *ibid*.

<sup>713</sup> *ibid*.

<sup>714</sup> Ayotte and Yun (n 708) 17.

harmonisation amongst different states in this area of law notwithstanding that the Basel Accords establish uniform standards to be applied by banks in order to cater for the risks which they face. The Basel Accords do not distinguish between financing parties operating in pro-creditor jurisdictions and financing parties operating in pro-debtor jurisdictions, notwithstanding the different risks to which they may be subject.

### **6.1.2 Different Approaches Towards Insolvency Law**

Different jurisdictions adopt different insolvency procedures, with the efficiency of these procedures also varying greatly<sup>715</sup>. This distinction is most profound when comparing pro-debtor systems with pro-creditor systems<sup>716</sup>.

Over the past few decades Wood has sought to map and rank jurisdictions according to whether they can be considered as pro-creditor or pro-debtor jurisdictions, basing his analysis on a number of key indicators<sup>717</sup>. The classification of jurisdictions established by Wood has been reproduced below, with the first jurisdictions listed being the most pro-creditor jurisdictions, and the last jurisdictions listed being the most pro-debtor (though Wood has recognized that other than for those jurisdictions listed in rank “one” and “ten” it might be legitimate to move some jurisdictions “up or down a rung or two in the scale”)<sup>718</sup>:

1. *Hong Kong, Singapore and other English-influenced states (about 80 of them);*
2. *Australia, England, Ireland;*
3. *Germany, Netherlands (and former Dutch states like Indonesia), Sweden, Switzerland;*
4. *Scotland, Japan, Korea, New Zealand, Norway;*
5. *United States, Canada (Quebec more pro-debtor);*
6. *Austria, Denmark, South Africa (and related states like Botswana and Zimbabwe);*
7. *Italy;*
8. *Greece, Portugal, Spain, most of Latin America;*

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<sup>715</sup> Succurro (n 696) 4.

<sup>716</sup> *ibid.*

<sup>717</sup> Wood 1995(I) (n 15) 98.

<sup>718</sup> *ibid.*



9. *Belgium, Luxembourg, many former French colonies;*

10. *France.*

Wood has recognised that this scale may be “*highly impressionistic*” and “*bound to be unreliable*” in light of the vast comparative research which would need to be undertaken to authenticate it, whilst he also specifies that various domestic elements, such as how certain rules are applied, and the underlying legal civilisation would also need to be considered in order to undertake a wholesome analysis<sup>719</sup>. He further notes that the classification he established is based on the legal rules of states, and does not look at the culture found in different states<sup>720</sup>. He however states that notwithstanding such essential qualifications, there is still value in adopting this analysis<sup>721</sup>.

Wood established the above scale by setting out a number of key determinants, to which he then attributed a “*score*” in order to be able to rank the different jurisdictions according to the score which each jurisdiction obtained in relation to each key determinant<sup>722</sup>. Some of the said key indicators (security, rehabilitation proceedings and set-off) were granted a higher weighting by Wood in light of their importance in considering whether a jurisdiction is pro-creditor or pro-debtor<sup>723</sup>. The key determinants used by Wood in determining the above scale are the following<sup>724</sup>:

1. *The scope and efficiency on bankruptcy of security and title financing (such as retention of title, factoring and financial leasing);*
2. *Insolvency set-off (enabling the reciprocal unsecured creditor to be paid ahead of other unsecured creditors);*
3. *Corporate rehabilitation statutes;*
4. *Ownership of assets in the possession of the debtor (trust, tracing);*
5. *Honouring the veil of incorporation and protection of directors against personal liability. This is an ambiguous factor since arguments can be made*

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<sup>719</sup> *ibid.*

<sup>720</sup> *ibid* 100.

<sup>721</sup> *ibid* 98.

<sup>722</sup> *ibid* 99.

<sup>723</sup> *ibid.*

<sup>724</sup> *ibid*; Wood does recognise that other indicators may also be added to the above, such as priority creditors, protection of good faith post-petition creditors and direct actions.

*that a weak veil is either pro-creditor or pro-debtor. But unquestionably a strong veil shows a business orientation;*

6. *Preferential transfers;*

7. *Contract and lease rescission.*

Notwithstanding that the historical classification of jurisdictions depended very clearly on whether jurisdictions were Napoleonic, based on English Common Law, or Roman-Germanic, in establishing the above scale Wood has come to the conclusion that it is unimportant as to whether jurisdictions are “*common law*” jurisdictions or “*civil law*” jurisdictions (other than for the possibility of using trusts) in classifying jurisdictions as being “*pro-debtor*” or “*pro-creditor*”<sup>725</sup>. He therefore states that it is not particularly relevant as to what format is used to write the relevant laws and that what is more relevant is the substantive content of those laws<sup>726</sup>. Wood has therefore noted that though jurisdictions may be split into different legal families, such as Napoleonic jurisdictions, Roman-Germanic jurisdictions and Anglo-American jurisdictions, the Roman-Germanic group and its related jurisdictions in the mixed civil law/ common law group include the second and third largest economies, being Japan and Germany, and with Luxembourg, being traditionally Napoleonic in nature, having the highest per capita income<sup>727</sup>. Furthermore, if one were to compare English law with the laws of the US, one would find that English law is more pro-creditor than the laws of the US in light of underlying policy choices which the different laws have established<sup>728</sup>.

Notwithstanding Wood’s analysis, one cannot ignore that certain civil law systems continue to be more ingrained in pro-debtor backgrounds in light of their historical origin, and though certain Civil Law jurisdictions have developed along the years to move towards a more pro-creditor stance, other jurisdictions may still be ingrained, whether fully or partially, in the historical Napoleonic system which sought to safeguard debtors as its starting point. Other authors therefore still continue to associate pro-creditor systems with Common law jurisdictions and pro-debtor systems with Civil law systems<sup>729</sup>.

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<sup>725</sup> Wood 1995(I) (n 15) 100; Ian F Fletcher, *The Quest for Global Insolvency Law: A Challenge for our Time* (Current Legal Problems, Vol 55, OUP, 2002) 430 <<http://clp.oxfordjournals.org/content/55/1/427.full.pdf>> accessed 14 April 2015.

<sup>726</sup> Wood 1995(I) (n 15) 100.

<sup>727</sup> Wood 2007 (n 15) 338.

<sup>728</sup> Fletcher (n 725) 430.

<sup>729</sup> Bergman and others (n 702) 6.

Wood also notes that where a country lies in the scale of being pro-debtor or pro-creditor is not influenced by how developed that particular jurisdiction is, and that a developed country or a developing country may be either a pro-debtor or a pro-creditor jurisdiction<sup>730</sup>. Cranston however argues that the more pro-creditor a jurisdiction is, the more this helps facilitate economic development particularly, given that pro-creditor jurisdictions are looked upon favourably by foreign investors<sup>731</sup>.

Burman has argued that though reduction of risk and credit enhancement systems are ultimately as old as pre-Roman commerce, the reform of secured finance laws over the past decades has become one of the “*most effective tools*” through which different jurisdictions enhance their credit capacity, thus encouraging financing parties to operate within their laws, allowing the opening up of modern trade and commerce and the development of infrastructure<sup>732</sup>.

### **6.1.3 Different Approaches Towards Credit Risk Mitigation Techniques**

Wood has argued that as laws develop in different jurisdictions, the problem of reaching “*international consensus*” on the “*three major risk mitigants*” (security interests, netting and set-off on insolvency, and the availability of the trust), will continue, as this has continued for at least the past two centuries, and he therefore did not envisage much harmonization taking place in relation to the laws which deal with credit risk mitigation techniques<sup>733</sup>. He envisaged that discussions relating to the laws of insolvency will continue in the medium term, and that arguments such as whether insolvency law should protect creditors or debtors, whether certain actors should receive favourable protection, and what degree of regulatory intervention and micro-management of the legal system there should be, will remain<sup>734</sup>. He argued that as legal systems become more complicated, new carve-outs will be created, with different legal systems becoming even more “*laddered or tiered or tranchéd*”<sup>735</sup>.

When considering the “*three major risk mitigants*”, Wood has argued that “*the traditional Napoleonic systems are negative on all of them, the Roman-Germanic systems are negative on one and a half of them and the Anglo-American systems are positive on all three*”, though he has recognised that this classification may consist of an “*extremely broad*

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<sup>730</sup> Wood 1995(I) (n 15) 100

<sup>731</sup> Cranston (n 47) 610.

<sup>732</sup> Harold S Burman, *The Commercial Challenge in Modernizing Secured Transactions Law* (Uniform Law Review, Vol 8, 2003-1/2, UNIDROIT, 2003) 348.

<sup>733</sup> Wood 2008 (n 15) 243.

<sup>734</sup> *ibid* 243 – 244.

<sup>735</sup> Wood 2007 (n 15) 338.

*generalization*"<sup>736</sup>. He therefore considers that: in Napoleonic jurisdictions, insolvency set-off is not permitted, with there being no universal trust, and whilst having "*relatively poor*" security interests; Roman-Germanic jurisdictions do have insolvency set-off, and with relatively strong security interests (being somewhere midway between Napoleonic and English common law systems), with the trust concept being largely rejected; and all Anglo-American common law systems have insolvency set-off, wide security interests, and the universal trust<sup>737</sup>.

Certain credit risk mitigation techniques, such as the availability of strong and effective security interests are also seen as an essential part of the equation for there to be economic growth, such that even before the World Bank grants loans to a developing country, it will normally examine the creation and protection of security interests in place in the respective jurisdiction, and support to less developed countries has only been extended upon such countries pursuing reforms in order to facilitate credit extension and on having available efficient default remedies<sup>738</sup>.

Notwithstanding the differences between jurisdictions and notwithstanding the lack of successful harmonisation initiatives in relation to credit risk mitigation techniques that will be discussed in Section 6.2, the Basel Accords do not distinguish between the varying underlying frameworks across different jurisdictions. The Basel Accords adopt a "*one-size-fits-all*" approach and assume that the same standards can be applied to all jurisdictions across borders and give rise to the same effects, notwithstanding the varying pro-debtor or pro-creditor stances which different jurisdictions adopt.

Though Wood recognizes that there have been vast areas of harmonisation of financial law along the years, he contends that this was possible as these represented "*comparatively easy areas and do not affect the fundamental issues*", and argues that the "*world has had little difficulty on agreeing on issues which are not insolvency-related*"<sup>739</sup>. He however notes that "*when insolvency intervenes, the international consensus stops*"<sup>740</sup>.

Goode has identified "*wide differences*" in "*philosophy and legal culture*" regarding the recognition of security and the conditions for the validity of security interests across

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<sup>736</sup> *ibid* 337.

<sup>737</sup> *ibid* 338.

<sup>738</sup> Goode (n 741) 47.

<sup>739</sup> Wood 2008 (n 15) 244.

<sup>740</sup> *ibid*.

different jurisdictions<sup>741</sup>. He states that common law jurisdictions “*are generally sympathetic to the concepts of party autonomy and self-help*”, and adopt a “*liberal attitude towards security*”, such as through the need of there being minimum formality for the grant of security, with the possibility of security being taken over both present and future assets, and with the possibility of securing both existing as well as future indebtedness<sup>742</sup>. Furthermore common law jurisdictions also allow universal security, rather than being limited solely to specific security<sup>743</sup>.

On the other hand, Goode states that civil law jurisdictions “*have been more cautious in their approach to non-possessory security and have been anxious about the “false wealth” which such practices are perceived as permitting*”<sup>744</sup>. Therefore the general rule in civil law jurisdictions is that specific security needs to be taken over specific assets; a notice may need to be given to a debtor as a perfection requirement for the validity of an assignment of debts (which will hence affect the validity and not merely the priority of such act); together with there being limitations on self-help remedies such as through the possession and sale of secured assets<sup>745</sup>.

The formalities required for the creation of security also vary between different jurisdictions – whilst Civil law jurisdictions typically require the existence of specific formalities in order for security to be perfected, it has been recognized that in Common law jurisdictions consensual security “*may be created in the most informal fashion in equity, even in the case of land*”, and that a mere agreement between the parties suffices<sup>746</sup>.

The ease of enforcement of security interests also varies greatly between Common Law jurisdictions and Civil Law jurisdictions, particularly in light of self-help remedies which are typically found in Common Law jurisdictions<sup>747</sup>. Whilst in Civil Law jurisdictions one would typically require access to the Courts in order to enforce a security interest, the notion of “*self-help*” found in Common Law jurisdictions grants secured creditors a:

*right to possess and sell his security, or appoint a receiver of it, without the aid of the court; to stipulate that the receiver is to be the agent of the debtor company,*

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<sup>741</sup> Roy Goode, *Security in Cross-Border Transactions* (Texas International Law Journal, Vol 33, 1998) 48; See also: Cohen (n 685) 176 – 177.

<sup>742</sup> Goode (n 741) 48.

<sup>743</sup> *ibid.*

<sup>744</sup> *ibid.*

<sup>745</sup> *ibid.*

<sup>746</sup> *ibid* 54.

<sup>747</sup> *ibid.*

*which is to be solely responsible for his acts, omissions and remuneration; to take over the management of a debtor company's business and to apply the profits towards discharge of the mortgage debt and interest*<sup>748</sup>.

In Common law jurisdictions such as in the UK, a creditor may avail himself of various rights over the debtor and over property held by the debtor, with these rights consisting of both self-help remedies, as well as of judicial remedies<sup>749</sup>. On default by a debtor, a creditor may (apart from having the possibility of accelerating a debt due, withholding his performance, and terminating the agreement), enforce his security interests by obtaining possession or enforcing the sale of particular assets, and by so doing be preferred over other creditors of the debtor<sup>750</sup>. Furthermore the creditor may also be entitled to set-off amounts due to him<sup>751</sup>. A creditor may also resort to judicial remedies, which may include the institution of proceedings against the debtor for “*payment, delivery, possession, foreclosure, or sale*”<sup>752</sup>.

Wood has ranked jurisdictions according to whether these can be considered as being “*sympathetic*” or “*hostile*” to security interests, such that he has considered most English-based common law countries (and to a lesser extent Sweden, Finland and Norway) as being “*very sympathetic*” to security interests, particularly in light of the possibility of taking a universal business charge over assets of a debtor which may be enforced through self-help remedies; jurisdictions such as Germany, Japan, Netherlands, Switzerland, Scotland and South Africa as being “*quite sympathetic*” to security interests (particularly as a result of the possibility of having fiduciary transfers taking place by way of security); jurisdictions such as Belgium, Luxembourg, Latin American countries, Greece and Spain as being “*quite hostile*” to security interests; and with jurisdictions such as Austria, France and Italy being classified as being “*very hostile*” to security interests<sup>753</sup>.

Wood has however also recognised that notwithstanding the above, most jurisdictions allow for mortgages to be taken over land, ships and aircraft, and therefore some

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<sup>748</sup> *ibid.*

<sup>749</sup> Roy Goode, *Principles of Corporate Insolvency Law* (Fourth Edition, Sweet & Maxwell, 2011) 7 – 8;

<sup>750</sup> *ibid.*

<sup>751</sup> *ibid.* 8.

<sup>752</sup> *ibid.*

<sup>753</sup> Wood 1995(II) (n 15) 127.

jurisdictions may be more pro-creditor when dealing with particular assets, thus resulting in lower risks for financing parties<sup>754</sup>.

Drobnig has, on the other hand, classified jurisdictions somewhat differently (when considering security interests in international insolvency proceedings), on stating that “[u]ndoubtedly the most creditor-prone country is the United States; followed by the Anglophonic Canadian provinces; then Europe, Germany; followed by the United Kingdom; and then by France”<sup>755</sup>. He specifically continues by drawing distinctions in relation to non-possessory security, and lists the US and most of the Anglo-Canadian provinces as being the most accommodating towards non-possessory security, and this as against Germany, England and France (with his comparison focusing on those countries which he considers “*hav[ing] advanced the farthest on the road to modern solutions for security interests in movables*”)<sup>756</sup>.

While this Section has sought to outline the varying approaches towards credit risk mitigation techniques across different jurisdictions, Section 7.1 will consider the main elements of each of these major credit risk mitigation techniques and how these vary across different jurisdictions.

## **6.2 Lack of Harmonisation of Laws**

### **6.2.1 Insolvency Law**

Though there has been “*substantial harmony and convergence of the underlying concepts*” of financial regulatory law, there continues to be considerable divergence in financial laws in light of the divergences on the laws of insolvency<sup>757</sup>. One of the proposals laid out in Chapter 9 of this thesis is that regulatory laws such as the Basel Accords (and their relevant implementing laws) can be used as a means to achieve a level of harmonisation of insolvency laws, with this possibly giving rise to harmonization across the different underlying laws within which the Basel Accords operate.

Having harmonization of underlying laws will add to the effectiveness of transnational regulatory laws such as the Basel Accords, given that this thesis argues that notwithstanding the existence of transnational regulatory laws such as the Basel Accords, these regulatory laws are rendered somewhat ineffective in light of the

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<sup>754</sup> *ibid.*

<sup>755</sup> Ulrich Drobnig, *Secured Credit in International Insolvency Proceedings* (Texas International Law Journal, Vol 33, 1998) 55.

<sup>756</sup> *ibid* 56.

<sup>757</sup> Wood 2007 (n 15) 332, 339.

different risks which financing entities are subject (and being dependent upon the particular jurisdiction within which they operate). It will here be argued that having incentives at the transnational level for insolvency laws to be harmonised is necessary in light of the various domestic policies and the traditional obstacles in each jurisdiction which continue to be an obstacle to reform, and in light of jurisdictions not being offered incentives to reform their domestic laws and regulations<sup>758</sup>. The proposal which will be put forward will therefore ensure that appropriate incentives are given to states to reform their laws to ensure that if insolvency risks are high, then this is appropriately reflected in their bank's credit risk calculations.

Cohen has stated that the differences in insolvency law, whether substantive or procedural, "*create a serious problem*" in international transactions and "*create one more battlefield to be survived in the eventual allocation of the debtor's assets*"<sup>759</sup>. Thus, as creditors typically seek risk aversion, greater uncertainty typically results in higher interest rates being charged on the advancement of credit<sup>760</sup>.

The concept of the "*centre of main interests*" has become the yardstick, in cross-border insolvency on seeking to determine the proper forum for the opening of insolvency proceedings, and this concept can be found in both the EU Insolvency Regulation as well as in the UNCITRAL Model Law on Cross-Border Insolvency<sup>761</sup>. In both the EU Insolvency Regulation as well as in the UNCITRAL Model Law on Cross-Border Insolvency, however, the underlying national insolvency laws still remain untouched, unchanged and unharmonised, such that substantial differences exist between different states<sup>762</sup>. One should here also be mindful of the fact that even getting different jurisdictions within the EU to agree to a conflict of law mechanism in insolvency has proved problematic – the EU Insolvency Regulation<sup>763</sup> was the result of negotiations which started back in 1960 (where a Convention was being proposed), and it was only

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<sup>758</sup> Buxbaum (n 687) 335; Ulrich Drobnig, *Brief Considerations on Co-ordinating Developments in the Field of Secured Transactions Law* (Uniform Law Review, Vol 8, 2003-1/2, UNIDROIT, 2003) 354.

<sup>759</sup> Cohen (n 685) 176.

<sup>760</sup> *ibid.*

<sup>761</sup> Fletcher (n 725) 436; Commission Staff Working Document SWD(2012) 416 final of 12 December 2012 accompanying the document Revision of Regulation (EC) No 1346/2000 on insolvency proceedings 19 (Commission SWD on insolvency); UNCITRAL Model Law on Cross-Border Insolvency (New York, 2014) <<http://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf>> accessed 11 September 2015.

<sup>762</sup> Fletcher (n 725) 439 – 440.

<sup>763</sup> Insolvency Regulation (n 199).



agreed to “*in a last-ditch effort to rescue the project from oblivion*”<sup>764</sup>. The formulation of the EU Insolvency Regulation as well as the UNCITRAL Model Law on Insolvency have therefore already been considered as tasks of great magnitude, in order to seek to have some form of alignment between different jurisdictions, and this notwithstanding that the outcome of these tasks has been limited to understanding which of the unchanged national laws are to apply to an insolvent entity<sup>765</sup>.

Other than the UNCITRAL Model Law on Insolvency one can also find the UNCITRAL Legislative Guide on Insolvency Law<sup>766</sup> which was formulated in 2005 and which aims to “*assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors*”, and “*to be used as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations*”<sup>767</sup>.

This lack of harmonisation has also come about in light of the various policy issues which insolvency gives rise to, such as protection of employees, and the important policy choice as to whether the law protects the insolvent party by seeking to maximise the assets available to it on insolvency, or whether it considers the rights of creditors and their recourse to amounts due to them and with this being dealt with in an expeditious manner (to the detriment of maximising the pool of assets belonging to the insolvent entity).

Having some degree of harmonisation of the laws on insolvency has become even more relevant in light of the ever increasing mobility of capital and goods and the need to ensure that the debtor’s assets are caught by the same proceedings and are not subject to multiple proceedings which may invariably give rise to different outcomes<sup>768</sup>.

#### **6.2.1.1 Harmonisation initiatives in the European Union**

As seen above, notwithstanding the vast legal harmonisation processes adopted in various fields by the EU, harmonisation in relation to insolvency laws has been limited to the Insolvency Regulation. This Regulation merely adopted a conflict of laws’ approach (with its main focus being on establishing the jurisdiction of insolvency proceedings, and

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<sup>764</sup> *ibid* 437; See also: Ian F Fletcher, *The European Union Convention on Insolvency Proceedings: Choice-of-Law Provisions* (Texas International Law Journal, Vol. 33, 1998).

<sup>765</sup> Fletcher (n 725) 443.

<sup>766</sup> UNCITRAL, *Legislative Guide on Insolvency Law* (United Nations, New York, 2005) <[https://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf)> accessed 2 November 2015.

<sup>767</sup> *ibid* 1; Goode (n 749) 18.

<sup>768</sup> Drobnič (n 755) 66.

ensuring recognition and enforcement of insolvency proceedings across EU borders), and establishes that insolvency proceedings will take place where a debtor's centre of main interests is, with other jurisdictions only having a secondary or a supporting role<sup>769</sup>. The EU Insolvency Regulation did not harmonise the substantive insolvency laws which different member states adopt<sup>770</sup>. This has also lead to forum shopping opportunities for both insolvent companies as well as to bankrupt individuals<sup>771</sup>.

The Insolvency Regulation has been replaced by the Recast Insolvency Regulation<sup>772</sup> on 26 June 2017<sup>773</sup>. It has nevertheless been argued that even here, the EU has been “*too cautious regarding the harmonisation of substantive insolvency laws of the Member States*”<sup>774</sup>. Therefore, though the Recast Regulation has sought to extend the provisions of the EU Insolvency Regulation, this has not brought any further harmonisation in the laws of the different member states and the amendments sought are mostly procedural and continue to be reliant on the “*centre of main interests*” as a conflict of laws mechanism<sup>775</sup>.

The main amendments which the Recast Regulation has introduced to the Insolvency Regulation are that: it has introduced a formal definition of “*centre of main interests*”<sup>776</sup> (as this concept was only referred to in the recitals of the Insolvency Regulation<sup>777</sup>), with there being a rebuttable presumption that the centre of main interests corresponds to the place of registered office of a company or of a legal person<sup>778</sup>; the scope of

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<sup>769</sup> Bliss (n 688) 50; Commission SWD on insolvency (n 761) 10.

<sup>770</sup> Commission SWD on insolvency (n 761) 10.

<sup>771</sup> The Recast Insolvency Regulation sought to limit the possibility of forum shopping by introducing a three-month look back period such that if a company would have relocated in the three month period prior to its insolvency, then the presumption of the centre of main interests being the place of its registered office would no longer hold. Horst Eidenmüller, *A New Framework for Business Restructuring in Europe: The EU Commission's Proposals for a Reform of the European Insolvency Regulation and Beyond* (European Corporate Governance Institute, Law Working Paper No. 199/2013, March 2013) 13 – 17 <[http://www.ecgi.org/wp/wp\\_id.php?id=550](http://www.ecgi.org/wp/wp_id.php?id=550)> accessed 10 August 2015; Richard Tett and Katharina Crinson, *The Recast EC Regulation on Insolvency Proceedings: A Welcome Revision* (Corporate Rescue and Insolvency, Vol 8.2, April 2015) 64 – 65; Recast Insolvency Regulation (n 199).

<sup>772</sup> Recast Insolvency Regulation (n 199).

<sup>773</sup> *ibid* Article 92.

<sup>774</sup> Eidenmüller (n 771) 1.

<sup>775</sup> *ibid* 4; Tett and Crinson (n 771) 64.

<sup>776</sup> Recast Insolvency Regulation (n 771) Article 3(1); Tett and Crinson (n 771) 64 – 65.

<sup>777</sup> Insolvency Regulation (n 199) Recital 13.

<sup>778</sup> This presumption would not hold, however, if the entity concerned would have changed its registered office to another Member State in the 3-month period prior to the opening of insolvency proceedings.

insolvency proceedings has been broadened in order to cater also for pre-insolvency proceedings<sup>779</sup>; mechanisms have been introduced in order to limit the need to open secondary proceedings<sup>780</sup>; and provisions have been inserted for there to be a voluntary group coordination proceeding where different members of the group are found in different member states<sup>781</sup>.

Eidenmüller argues that the recent amendments to the Insolvency Regulation present themselves as a missed opportunity since harmonisation is essential and “*clearly necessary for the efficient administration of cross-border insolvencies*”<sup>782</sup>. He therefore refers to the need for harmonisation in order to avoid forum shopping in relation to the differences regarding the deadlines a debtor must meet when the opening of insolvency proceedings is mandatory; as well as the need to have uniform security interests in relation to movable property (rather than relying on the *lex situs* rule)<sup>783</sup>.

The EU has, over the past few years also sought to tackle ancillary issues such as through a Commission Recommendation on a new approach to business failure and insolvency<sup>784</sup>. This Commission Recommendation seeks to give entities which are likely to be subject to insolvency proceedings the possibility of staying creditor proceedings and establishing a framework for restructuring of the particular entity (including through the use of mediators or supervisors for negotiations to take place between the particular debtor and the debtor’s creditors)<sup>785</sup>. One should here also point out that though this framework is only subject to a Commission Recommendation (and cannot therefore be considered as a harmonisation mechanism), the provisions of the Recast Insolvency Regulation also apply to restructurings contemplated by the said Commission Recommendation<sup>786</sup>. One should also note that the effects of this Commission Recommendation have the potential of making the general approach of European laws more pro-debtor rather than pro-creditor, thereby increasing risks which financing entities face.

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<sup>779</sup> The Recast Regulation does not go into the substantive elements of pre-insolvency proceedings; Tett and Crinsom (n 771) 64 – 66.

<sup>780</sup> Tett and Crinsom (n 771) 64, 66 – 67.

<sup>781</sup> *ibid* 64, 67 – 68.

<sup>782</sup> Eidenmüller (n 771) 8.

<sup>783</sup> *ibid* 8 – 9.

<sup>784</sup> Commission Recommendation C(2014) 1500 final on a new approach to business failure and insolvency [2014] (EU Insolvency Recommendation).

<sup>785</sup> *ibid*.

<sup>786</sup> Recast Insolvency Regulation (n 771); Tett and Crinsom (n 771) 66.

The 2012 Impact Assessment which led to the Recast Insolvency Regulation<sup>787</sup> set out a relatively pro-debtor approach to businesses in financial distress, by giving particular importance to the need for maximisation of asset value, given that it argues that this will provide better recovery rates for creditors<sup>788</sup>. This Impact Assessment considered three possibilities in order to tackle the main problems faced with cross-border insolvencies in the EU, and which consisted of either retaining the status quo; or “*modernizing the existing Regulation while preserving the current balance between creditors and debtors and between universality and territoriality*” (referred to as “*Option A*” in the said Impact Assessment); or of “*modifying the fundamentals of the Regulation and requiring some approximation or convergence of national insolvency laws and proceedings*” (referred to as “*Option B*” in the said Impact Assessment), and with the latter option thereby leading to harmonisation of national insolvency laws across the EU<sup>789</sup>.

The Commission however felt that more comparative analysis was required prior to resorting to Option B and prior to there being substantive harmonisation of insolvency laws, and this notwithstanding that the said Impact Assessment concluded that Option B would be more effective than Option A in “*reaching the objectives and providing economic and social benefits for the Single Market*”<sup>790</sup>. The Impact Assessment therefore stated<sup>791</sup>:

*The approximation of national insolvency laws and procedures would...require an in-depth comparative-law analysis of national insolvency laws and procedures which would enable the Commission to identify the precise areas in which procedural harmonisation would be necessary and feasible, and not too intrusive to the national legislations and insolvency systems.*

It was therefore concluded that Option A “*seems a more proportionate option at this stage*”<sup>792</sup>. As a result, laws of different member states continue to be different and rely solely on conflict of law provisions as seen above.

## 6.2.2 Security Interests

Similar to the laws on insolvency, harmonisation of laws in relation to security interests has also been very limited<sup>793</sup>. According to Cohen this lack of harmonisation “*lower[s]*

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<sup>787</sup> Commission Staff Working Document SWD(2012) 416 final (pg 11).

<sup>788</sup> Eidenmüller (n 771) 6.

<sup>789</sup> Commission SWD on insolvency (n 761) 31 – 45.

<sup>790</sup> *ibid* 45 - 46; Eidenmüller (n 771) 7.

<sup>791</sup> Commission SWD on insolvency (n 761) 44; Eidenmüller (n 771) 7.

<sup>792</sup> Commission SWD on insolvency (n 761) 46.

<sup>793</sup> Drobnig (n 755) 62; Cohen (n 685) 176.

*the expected value of a transaction to the creditor*”, particularly since when security interests provide certainty and are effective, they act in order to preserve the creditor’s interests on the insolvency of their debtors and leave the creditor in a better position<sup>794</sup>.

It has been argued that in light of further globalization, cross-border commercial finance requires further harmonization in order to provide predictability to financing parties, as well as to reduce risks – thus bringing credit into a number of markets and reducing the costs associated with higher risks<sup>795</sup>. Buxbaum has thus stated that parties are subject to higher costs, in light of there being more substantial risks on the application of less modernised law on security interests, therefore leading to more expensive credit<sup>796</sup>. Burman has also noted that along the years the structure of secured finance has often had a “*significant effect*” on the types of parties who can most readily grant credit, the types of businesses it favours, the types of property interests which gain preeminence as collateral, and he argues that many jurisdictions rely quite heavily on movables (both tangibles and intangibles) as prime collateral<sup>797</sup>. It has therefore been recognized that harmonisation on the laws of secured transactions and having an efficient enforcement system is necessary in order to ensure better access to credit, and to substantially lower borrowing costs<sup>798</sup>.

On UNIDROIT’s 50th anniversary, Matteucci highlighted the main issues which bodies tasked with the unification of such laws on security interests faced, with the main concerns primarily consisting of<sup>799</sup>: the question as to whether harmonisation should take place through substantive unification, or alternatively through unification of private international law principles; whether unification of law should only be limited to international transactions, or alternatively whether it should also be sought for domestic law matters; and whether to seek to achieve “*organic unification*” or alternatively whether one should focus on specific legal relations.

Bazinas’ 1980 report entitled “*UNCITRAL’s Work in the Field of Secured Transactions*” also concluded that the differences amongst the various legal systems in relation to secured transactions were too great to allow for there to be unification of law, and therefore UNCITRAL had here concluded that unification of law in relation to security

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<sup>794</sup> Cohen (n 685) 176.

<sup>795</sup> Burman (n 732) 349.

<sup>796</sup> Buxbaum (n 687) 324.

<sup>797</sup> Burman (n 732) 351.

<sup>798</sup> Goode (n 548) 342.

<sup>799</sup> Buxbaum (n 687) 321.

interests was not feasible<sup>800</sup>. Burman also noted how in the mid-1990s harmonisation of secured transactions law was placed on the “*“impossible” list*”, and “*consigned to the dustbin because of deep differences in legal traditions, the uses of commercial law, and legislative and cultural differences in changing long-standing law*”<sup>801</sup>.

Cohen, however, writing in 1998, has been much more positive on the potential for harmonization of the laws on secured credit due to a number of economic and political changes which took place in the preceding years, due to which harmonization initiatives would not have required jurisdictions to revamp their laws in order to be receptive to harmonization initiatives<sup>802</sup>. In Cohen’s view, the period 1977 – 1997 dramatically changed the international secured transactions’ landscape and that as new initiatives “*mushroomed*”, the prospect of “*modernization and harmonization are no longer far-fetched dreams*”<sup>803</sup>. He therefore stated that the degree of harmonisation in the decade leading up to 1997, provided harmonisation of law which would have been “*not imaginable only twenty years ago*”<sup>804</sup>.

On the other hand, Wood has been of the view that in the medium term there will be more “*splintering and fragmentation*” of the laws on insolvency and security interests, rather than further harmonisation, which he envisages will be “*a shattering like a stone hitting a windscreen*”<sup>805</sup>. This however contrasts with Goode’s view who has argued that<sup>806</sup>:

*States all over the world have had to recognize that a diversity of national laws is no longer adequate to meet the needs of the market place, and that long-standing legal traditions, concepts and techniques, however laudable in their objectives, must now be modified so as to be responsive to the needs of commerce and finance, which require above all the minimum degree of formality and the maximum degree of flexibility.*

Furthermore, in 2003 Goode stated that in the previous two decades:

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<sup>800</sup> *ibid* 322.

<sup>801</sup> Burman (n 732) 347.

<sup>802</sup> Cohen (n 685) 179 – 180, 183.

<sup>803</sup> *ibid* 180.

<sup>804</sup> *ibid* 188; Similarly, Buxbaum argued in 2001 that the legal environment and the potential for unification was different to that described by Bazinas in 1980, see: Buxbaum (n 687) 322.

<sup>805</sup> Wood 2008 (n 15) 243; Wood 2007 (n 15) 338.

<sup>806</sup> Goode (n 548) 343.

*we have come to appreciate the importance of a sound legal regime for security interests in personal property, both for domestic and for cross-border transactions, and the fact that property rights and their protection against insolvency need not be a no-go area for the harmonisation process*<sup>807</sup>.

Nevertheless, according to Goode having international harmonization of personal property security law is “*wholly unrealistic*” given that the law is “*too complex and the differences between national laws too great*”, though Goode does recommend that states resort to model laws and Conventions dealing with specific types of security interests in order to limit the problems faced on the international plain<sup>808</sup>.

However, notwithstanding the importance of security interests and the positive predictions in relation to harmonization of laws on security interests, this has been very limited, and even in regional groupings such as in the EU there have been very limited attempts towards unification of these laws<sup>809</sup>. The lack of harmonization can also be seen as a result of a proposal which has been put forward by the European Commission in May 2017, whereby an “*accelerated loan security*” has been proposed to be put in place whereby banks will be able to recover value from secured loans in the event of there being a default<sup>810</sup>. This continues to show how despite the harmonization of laws regulating banks’ risks, the actual risks to which such banks are subject vary substantially from one jurisdiction to another.

Therefore, a further 20 years after Cohen’s writing, the lack of harmonization of laws on security interests continues to be evident. This problem has been even more exacerbated by the fact that there continues to be uncertainty, in day to day transactions, as to the laws of which states apply, particularly in light of the complex conflict of law rules which apply in different jurisdictions, thus leading to parties to a transaction to take different types of security in the different jurisdictions in which they operate,

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<sup>807</sup> *ibid* 341.

<sup>808</sup> Goode (n 741) 49 – 50.

<sup>809</sup> Drobnig (n 755) 63.

<sup>810</sup> European Commission, *Accelerated Loan Security: Strengthening the Ability of Banks to Recover Value from Secured Loans in case of Borrower Default* (Directorate-General for Financial Stability, Financial Services and Capital Markets Union, Non-Paper for the Financial Services Committee, 18 May 2017). Moreover, another step in the right direction is the Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral published on the 14 March 2018, in that this proposed directive will ensure accelerated extrajudicial collateral enforcement, though it is yet too early to see how this proposal will be developing over the coming months (See: European Commission, *Proposal for a Directive of the European Parliament and of the Council on Credit Servicers, Credit Purchasers and the Recovery of Collateral* (COM(2018) 135 final, 2018/0063 (COD), Brussels, 14 March 2018).

notwithstanding substantial overlaps which may be created in the security taken, in order to ensure that the creditor continues to be sufficiently protected<sup>811</sup>.

The lack of harmonisation is even more surprising as the proliferation of transnational laws and regulation in other areas of law has been one of the main developments over the past two decades. It will therefore be argued that the time is ripe for new initiatives to be adopted in order to achieve harmonization, particularly in light of the wider regulatory frameworks which have become ever more harmonized, and also in light of the fact that this will enhance the effectiveness of transnational regulatory measures such as the Basel Accords.

#### **6.2.2.1 Harmonisation initiatives**

In the absence of there being unification in both the laws on insolvency as well as in the laws on security interests, conflict of law principles have had to be resorted to in order to determine the proper laws to apply when varying security interests may be obtained over particular assets<sup>812</sup>. In Goode's view, resorting solely to conflict of laws, without unification of laws, is however "*inherently unsatisfactory*", particularly in light of the need to apply domestic laws to international transactions<sup>813</sup>.

The general conflict of law rule is that corporeal movables are governed by the *lex rei sitae*, such that the particular asset becomes subject to the laws of the place of the location of the said asset (though difficulties may arise in light of the wide ranging differences in non-possessory security interests amongst different jurisdictions)<sup>814</sup>. One should also note that in light of the international mobility of means of transport, which due to their nature venture across national borders on numerous occasions, the proper law of security taken over assets such as vessels and aircraft, is usually determined by the state of registration (rather than by the *lex rei sitae*) of the particular asset (with this usually coinciding with the law of the flag or nationality)<sup>815</sup>.

On the other hand the situation is somewhat different with regard to intangibles, in light of the fact that intangibles may invariably not have an unambiguous *situs*<sup>816</sup>. Therefore the Rome Convention on the Law Applicable to Contractual Obligations of 1980 established conflict of law provisions in order to regulate this, with the main concept

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<sup>811</sup> Cohen (n 685) 177.

<sup>812</sup> Drobniig (n 755) 63.

<sup>813</sup> Goode (n 741) 49.

<sup>814</sup> Drobniig (n 755) 63 – 64.

<sup>815</sup> *ibid* 64.

<sup>816</sup> *ibid*.



found in the Rome Convention being that intangibles which are assigned will be governed by the law governing the assigned receivable, therefore moving from the *lex rei sitae* to the *lex contractus*<sup>817</sup>. The general presumption here is that the same rules governing assignments will also govern the pledging of receivables<sup>818</sup>. The Rome Convention has since been replaced by the Rome I Regulation which has incorporated the same concepts<sup>819</sup>.

Drobnig has sought to highlight the main initiatives entered into by different jurisdictions which sought to achieve some degree of uniformity in relation to the laws on security interests<sup>820</sup>, and has also referred to two proposals which had been put forward and which consisted of a range of possible unification schemes: the 1968 UNCITRAL proposal; and the 1972 proposal put forward by the Service de Recherches Juridiques Comparatives of the CNRS of Paris<sup>821</sup>. Drobnig has however stated these attempts at achieving uniformity were all ineffective, and has stated that “*transnational incidence of security interests is as yet relatively moderate*” and that it:

*would probably be difficult to obtain sufficient government support for an international conference dealing with the relatively technical topic of security interests; and even if the text of an international interest could be agreed upon, national parliaments would probably be slow and perhaps even reluctant to ratify such a text*<sup>822</sup>.

He has recognized that “[t]he only area recording some successful international legislation for security rights is in certain means of transport”<sup>823</sup>. International recognition of security rights in aircraft have been recognised as from the Geneva Convention of 1948<sup>824</sup>, with this Convention being highly successful (though this only established

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<sup>817</sup> *ibid* 64 – 65.

<sup>818</sup> *ibid* 65.

<sup>819</sup> Article 24, Regulation (EC) No 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations [2008] OJ L 177 (Rome I).

<sup>820</sup> These initiatives included: (a) the Uniform Conditional Sales Act (entered into by Norway, Sweden and Denmark, 1915 – 1917); (b) the UNIDROIT draft provisions concerning the impact of reservation of title in the sale of certain goods (1939, 1951); (c) the provisions regarding the effect of bankruptcy of reservation of title in the sale of goods in the draft EEC Bankruptcy Convention (1970); and (d) the model reservation of title clauses contained in several “General Conditions” (as elaborated by the United Nations Economic Commission for Europe); See Cohen (n 685) 178.

<sup>821</sup> Cohen (n 685) 179.

<sup>822</sup> *ibid*.

<sup>823</sup> Drobnig (n 755) 62; Cohen (n 685) 178 – 179.

<sup>824</sup> Convention on the International Recognition of Rights in Aircraft (Geneva, 1948).

conflict of laws rules)<sup>825</sup>. This has furthermore been supplemented by the CTC which will be analysed in further detail in Chapter 8<sup>826</sup>. On the other hand, various other initiatives, such as on ship mortgages and maritime liens have only had limited success<sup>827</sup>.

Drobnig dismissed the usefulness of the adoption of “*recommendations*” for states to adopt in seeking to achieve uniformity of security interests<sup>828</sup>. He therefore stated: “[m]ere recommendations, even if emanating from an international organization of the highest repute, will not command sufficient moral or other support for adoption by any sizeable number of States”<sup>829</sup>. His view was however “*less bleak*” when considering the possibility of developing model laws on security interests, though he stated that “[p]erhaps moral persuasion or intellectual insight into the virtues of the model rules will move some States to adopt them. Others may need persuasion by more effective means such as insistence on the part of international financing institutions”<sup>830</sup>.

Harmonisation has also been sought, along the years, in relation to specific instruments which seek to provide security interests or similar rights. One of these initiatives has been in relation to factoring – though factoring generally involves a sale of an asset, rather than a credit transaction, this is so closely associated with secured credit (historically and functionally), such that it is typically also governed by secured credit laws<sup>831</sup>. In light of the cross-border nature of factoring, the 1988 UNIDROIT Convention on International Factoring was seen as a landmark which showed that it is indeed possible to reach international agreement on complex legal issues in relation to international secured finance<sup>832</sup>. Similarly in 1988 the UNIDROIT Convention on International Financial Leasing was also agreed to<sup>833</sup>. Both the UNIDROIT Convention on

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<sup>825</sup> Drobnig (n 755) 62.

<sup>826</sup> Burman (n 732) 347.

<sup>827</sup> Drobnig (n 755) 62.

<sup>828</sup> Cohen (n 685) 179.

<sup>829</sup> Ulrich Drobnig, *International Payments – Report of the Secretary-General: study on security interests (A/CN.9.131)* (Yearbook of the United Nations Commission on International Trade Law, Vol VIII, 1977) 218.

<sup>830</sup> *ibid*; Cohen (n 685) 179.

<sup>831</sup> Cohen (n 685) 181.

<sup>832</sup> *ibid* 182; Buxbaum (n 687) 329.

<sup>833</sup> Buxbaum (n 687) 329.

International Factoring and the UNIDROIT Convention on International Financial Leasing came into force on 1<sup>st</sup> May 1995<sup>834</sup>.

UNCITRAL has also sought harmonisation on the laws which govern international accounts receivable financing, through the 2001 Convention on the Assignment of Receivables in International Trade<sup>835</sup>. This Convention, which follows on Article 9 of the Uniform Commercial Code (“UCC”) (which in itself had already been a very important harmonisation initiative in the different states of the US and through which the US obtained a harmonized law on security interests which could be applied consistently throughout), would govern any international assignment of a receivable and any assignment (domestic or international) of an international receivable (i.e. where the debtor and the creditor are in different jurisdictions)<sup>836</sup>. This Convention has therefore sought to provide clarity to a myriad of issues which arise in light of there being an account holder (or account debtor), an account creditor (who will be the debtor of the secured party and the assignor of the credit), and the creditor (who is also the assignee and will also be the secured party), with all these parties potentially also being situated in different jurisdictions<sup>837</sup>. This Convention however is yet to enter into force<sup>838</sup>.

The Legislative Guide on Secured Transactions<sup>839</sup> was also developed by UNCITRAL, and also placed great reliance on Article 9 of the US UCC. McCormack has however been critical of this since he considers that this “*neglects reference to indigenous secured credit law norms that also reflect national social policy choices in a range of countries*”<sup>840</sup>. He therefore states that the UNCITRAL Secured Transactions Guide to reform the law worldwide along neoliberal American lines is “*fraught with difficulty not least by*

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<sup>834</sup> UNIDROIT Convention on International Factoring (Ottawa, 1988) <<http://www.unidroit.org/status-1988-factoring>> accessed 4 September 2015; UNIDROIT Convention on International Financial Leasing (Ottawa, 1988) <<http://www.unidroit.org/status-leasing-conv-1988>> accessed 8 September 2015.

<sup>835</sup> Cohen (n 685) 182; Burman (n 732) 347; Buxbaum (n 687) 329.

<sup>836</sup> Cohen (n 685) 181.

<sup>837</sup> *ibid* 182 – 183.

<sup>838</sup> United Nations Convention on the Assignment of Receivables in International Trade (New York, 2001) <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/security/2001Convention\\_receivables\\_stat\\_us.html](http://www.uncitral.org/uncitral/en/uncitral_texts/security/2001Convention_receivables_stat_us.html)> accessed 8 September 2015.

<sup>839</sup> UNCITRAL Legislative Guide on Secured Transactions (New York, 2010) <[https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670\\_Ebook-Guide\\_09-04-10English.pdf](https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf)> accessed 10 September 2015.

<sup>840</sup> Gerard McCormack, *UNCITRAL, Security Rights and the Globalisation of the US Article 9* (Northern Ireland Legal Quarterly, Vol. 62, Issue 4, 2011) 485.

*overlooking the regulatory and cultural plurality of the countries on which it seeks to have an impact*<sup>841</sup>.

The European Bank for Reconstruction and Development issued its Model Law on Secured Transactions in 1994, with this having been drafted for the purpose of serving as a model modern secured transactions law, particularly for the Central and Eastern European jurisdictions<sup>842</sup>. Other regional projects for the development of modern secured credit laws have also been in place along the years<sup>843</sup>.

In 2002 the Model Law on Secured Transactions, sponsored by the Organization of American States was also adopted<sup>844</sup>. The drafting of this Model Law sought to build on common elements found in different legal systems in order to establish a Model Law which could uniform and harmonise laws on non-possessory secured credit financing and which could be adopted by different states, notwithstanding their varying legal cultures, thereby seeking to ensure the ease of access to credit with the resulting economic benefits which this brings<sup>845</sup>. The OAS Model Law creates a uniform system for all non-possessory interests in movable property by way of single registry and priority system. For this purpose the OAS Model law was complemented by the 2009 OAS Model Registry Regulations<sup>846</sup>.

Notwithstanding these initiatives, the laws on security interests continue to vary across different jurisdictions, and harmonisation initiatives have not been particularly successful (including in economic groupings such as the EU); consequently financing entities in different jurisdictions are subject to different underlying laws. Against this backdrop, Chapter 9 will propose that the Basel Accords themselves can also be used as a method in order to encourage different jurisdictions to adopt uniform laws on security

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<sup>841</sup> *ibid* 487.

<sup>842</sup> Cohen (n 685) 183 – 184; Buxbaum (n 687) 332.

<sup>843</sup> See also: Cohen (n 685) 183 – 186; Buxbaum (n 687) 332 – 335; Jan-Hendrik Röver, *Comparative Principles of Security Interests: Secured Debt and Charged Property* (Ph.D. Thesis, King's College London, 2004) 54 – 75.

<sup>844</sup> Burman (n 732) 347 – 348.

<sup>845</sup> Ronald Herbert, *Rapporteur's Report on Committee II (Secured Transactions): Report of the Rapporteur of Committee II International Loan Contracts of a Private Nature, in Particular, the Uniformity and Harmonization of Secured Transactions Law* (Organization of American States, 10 June 2002)

<[http://www.oas.org/en/sla/dil/docs/secured\\_transactions\\_CIDIP\\_VI\\_Rapporteur\\_II.pdf](http://www.oas.org/en/sla/dil/docs/secured_transactions_CIDIP_VI_Rapporteur_II.pdf)>

accessed 1 October 2015; See also: Boris Kozolchyk, *Implementation of the OAS Model in Latin America: Current Status* (Arizona Journal of International & Comparative Law, Vol 28 No 1, 2011); Karen B Brown, David V Synder, *General Reports of the XVIII<sup>th</sup> Congress of the International Academy of Comparative Law* (Springer Science & Business Media, 30 December 2011) 332.

<sup>846</sup> Brown and Synder (n 845) 332.

interests (using the same methodology adopted by the CTC, as further described in Chapter 8 of this thesis), with this in turn being used as a means through which differences arising from the laws of different jurisdictions are reduced.

### **6.3 *Domestic Embeddedness and the Basel Accords***

Section 2.2.2.3 of this thesis has argued that transnational regulatory laws are affected by domestic embeddedness, cultural embeddedness and domestic preferences, such that what is agreed to in a transnational law or in a transnational regulatory law will necessarily be subject to different approaches, different methods of implementation and different enforcement mechanisms across different jurisdictions. These variances are therefore bound to arise in light of different underlying laws across different jurisdictions and within which a transnational law or a transnational regulatory law are meant to operate; in light of the way of “*doing things*” in a particular jurisdiction; and also in light of preferences which society as a whole may have.

Whilst it may be a close to impossible task to analyse certain cultural or societal preferences across jurisdictions and in relation to a particular transnational regulatory law such as the Basel Accords, this thesis refers to literature which studies the main underlying laws which affect financing entities which the Basel Accords seek to regulate. Although the Basel Accords’ (current) main aim is that of regulating risk in order to minimise systemic risks, this thesis argues that financing entities operating across different jurisdictions are subject to different levels of risk due to different underlying laws within which they operate.

This Chapter has shown how different underlying laws in different jurisdictions can lead to jurisdictions being classified as more “*pro-creditor*” or “*pro-debtor*” than others, depending on the types of laws they adopt, and due to implicit policy choices which form part of these different national laws. Furthermore, it has also been shown that notwithstanding the recognition that laws on insolvency and on security interests are fundamental in order to assist financing parties, there have only been few harmonization attempts, and various authors have been of the view that harmonization on these topics is very difficult to achieve. This can also be seen from the policy choices adopted at EU level, such that even in this regional grouping there are yet to be harmonized insolvency laws or harmonized laws on security interests – other than systems based on conflict-of-laws which determine which national law is to apply in cross-border situations, and as a result of there being a lack of harmonisation.

It is therefore here argued that the Basel Accords cannot reach their full potential unless it is recognized that further importance needs to be given to the consideration of whether a particular entity operates in a pro-creditor or in a pro-debtor jurisdiction. Furthermore, in such instance the drafters of the Basel Accords will need to choose between two different options: either that of providing different regulatory regimes for financing entities which operate in different jurisdictions (with entities operating in pro-debtor jurisdictions being subject to stricter capital adequacy requirements); or alternatively seeking to create incentives in order to encourage different jurisdictions to adopt similar underlying laws on insolvency and security interests.

Having different jurisdictions adopting similar laws on insolvency and security interests will mean that the effectiveness of the Basel Accords will increase, since the drafters of the Basel Accords will be able to understand each other better and adopt a regulatory system which reaches the same effects across different jurisdictions. Once similar underlying laws are adopted, financing entities established in different jurisdictions will be subject to comparable risks, meaning that the starting point of the transnational regulatory law would be very similar to all the subjects of such regulation (notwithstanding that certain differences arising from cultural and domestic preferences may still arise).

Whilst one may argue that creating similar underlying laws and harmonization on the laws of insolvency and security interests is a highly challenging task, Chapter 8 will draw upon the CTC in order to show how a transnational law has been capable of harmonizing laws on insolvency and security interests across borders. It will be argued that this can be used as a model which the BCBS should refer to in order to solve the problem of domestic embeddedness.

## **Chapter 7: Limitations of the Basel Accords arising from Differences in the Laws of Different States**

This Chapter will commence by considering the importance of credit risk mitigation techniques, and how these vary amongst different jurisdictions. It will then continue by showing how notwithstanding the importance given to credit risk mitigation techniques by financing entities, during the transactional stage (and on seeking to reduce their risks on extending finance to third parties), most of these credit risk mitigation techniques are overlooked by the Basel Accords.

### ***7.1 Different Types of Credit Risk Mitigation Techniques***

On financing counterparties, banks and financing parties seek to reduce the risks they are subject to through the use and availability of credit risk mitigation techniques which may be made use of in the particular jurisdictions within which they operate. The stronger certain credit risk mitigation techniques are, and the more pro-creditor jurisdictions are (as discussed in Chapter 6), the less are such banks and financing entities exposed to credit risk. Notwithstanding that banks and financing parties consider the need for collateral and the potential exposure which they may have to individual transactions, on each transaction entered into, and on seeing that it makes commercial sense to enter into such a transaction, it is argued here that these considerations are not given due importance in the regulatory framework and particularly in the Basel Accords.

In light of the importance of the strength of credit risk mitigation techniques and of having pro-creditor insolvency laws for financing entities, one should also point out that pro-debtor systems increase contagion risks in the financial system: as banks and financing entities struggle to recoup funds owed to them or to enforce security interests which may have been given in their favour, the risk of a financing entity becoming insolvent increases, thereby possibly increasing the downward spiral of a financial system. This is particularly relevant to banks given that the business model of banks is reliant on maturity transformation, whereby they borrow for the short term, but hold assets and lend for the medium and long term<sup>847</sup>. Banks are therefore faced with a problem if they cannot recoup moneys due to them within the short term as this may also affect their liquidity positions.

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<sup>847</sup> Wood 2008 (n 15) 241.

Wood has outlined the existence of “*three major risk mitigants*” being security interests, insolvency set-off, and the availability of trust<sup>848</sup>. The main feature of these risk mitigants is that they protect creditors, rather than seek to enlarge a debtor’s estate<sup>849</sup>. Each of these three different types of credit risk mitigants will be considered in further detail, though security interests will be the main focus of this thesis. For this purpose the laws of various jurisdictions will be considered, particularly in order to highlight differences between pro-creditor and pro-debtor jurisdictions.

### 7.1.1 Security Interests

Security interests allow creditors to have preferential rights over other creditors in relation to particular assets, with the rationale for this being that a secured creditor should be preferred over other unsecured creditors since he would have bargained for that right and since that would be the basis on which the said creditor would have based his decision to provide credit to his debtor<sup>850</sup>.

It has been stated that security interests lie at the “*crossroads of two conflicting principles*”, being the preferred treatment of creditors on the one side, and the principle of equality of creditors on insolvency (*pari passu*) on the other<sup>851</sup>.

Wood has identified two main characteristics of “*security*”, as follows<sup>852</sup>:

- *The creditor can force a sale of the property and use the proceeds to pay the secured debt ahead of other creditors; or*
- *The debtor can insist on a release of creditors’ rights of realisation on payment of the secured debt.*

Collateral is generally obtained through the pledging, hypothecating, mortgaging, or charging of assets by the borrower himself or by a guarantor (at times referred to as an “*obligor*”), or even by entering into certain title finance transactions such as sale and repurchase agreements, for the benefit of an obligee (who for the purposes of this thesis will typically be the bank)<sup>853</sup>. The effect of such collateral is such that it can transform the borrower’s credit risk to the risk on the asset being provided as collateral<sup>854</sup>.

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<sup>848</sup> Wood 2007 (n 15) 336.

<sup>849</sup> *ibid.*

<sup>850</sup> Goode (n 741) 57.

<sup>851</sup> Drobniig (n 755) 54.

<sup>852</sup> Wood 1995(II) (n 15) 127.

<sup>853</sup> Deloitte, *Collateral Management & Credit Mitigation: Reducing Risk Exposure* (Deloitte Luxembourg, 2014) 3 <<http://www.deloitte.com/assets/dcom->



Security interests may either be “*personal*”, such as the grant of a guarantee (suretyship) or indemnity in favour of a secured party, or alternatively “*real*” (at times also referred to as “*proprietary*”) which means that specific assets of the debtor’s property are granted to the creditor as security for the amounts due<sup>855</sup>. “*Real*” security provides security “*in an asset or pool of assets*”, which may take the form of a mortgage or some other charge over specific assets or a class of existing and future assets<sup>856</sup>. “*Personal*” security on the other hand provides an undertaking by the debtor himself or by a third party, such as through the provision of a guarantee<sup>857</sup>.

Formalities for granting of security interests however vary widely from one jurisdiction to another. Whilst some jurisdictions require no formalities for the grant of security interests, others require the drawing up of a contract between the parties, the registration of a contract with a public registry, the registration of a security interest without there being a formal document, or even the marking of the encumbered asset in order to show that this is subject to a security interest (or alternatively of the advertising to the public at large that a certain security interest has been put in place)<sup>858</sup>.

Goode considers that certain security interests are unique to particular jurisdictions and may not have specific counterparts in other jurisdictions<sup>859</sup>. He therefore refers to the English floating charge, by way of example, given that this is unknown outside England and certain Commonwealth jurisdictions based on English law<sup>860</sup>. Different regimes therefore differ in various aspects, such as whether they provide unified treatment for all security interests or whether separate regimes apply for specific types of security interests; the types of property over which a security interest may be granted; the creditors in whose favour a security interest may be granted; the ability of a debtor to grant a security interest in after-acquired or subsequently-created property; the applicable rules of priority; as well as whether transactions which are security interests

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[luxembourg/local%20assets/documents/brochures/english/2010/lu\\_en\\_collateralmitigation\\_15092010.pdf](http://luxembourg/local%20assets/documents/brochures/english/2010/lu_en_collateralmitigation_15092010.pdf)> accessed 7 October 2014; Wood (n 1) 637 – 638.

<sup>854</sup> Deloitte (n 853) 3.

<sup>855</sup> Drobnig (n 755) 54; Cohen (n 685) 175 – 176; Goode (n 749) 5.

<sup>856</sup> Goode (n 749) 5.

<sup>857</sup> *ibid.*

<sup>858</sup> Drobnig (n 829) 180 – 185.

<sup>859</sup> Goode (n 741) 48.

<sup>860</sup> *ibid.*

“*in substance*” but not “*in form*” (such as conditional sales) are governed by the laws of security interests or otherwise<sup>861</sup>.

Traditionally, English common law and equity recognized three major types of consensual security interests: a mortgage, a charge and a pledge (though Goode has also included “*contractual liens*” as a fourth category of security and which provides for a right of detention of an asset by way of security (and does not grant rights to sell the said asset))<sup>862</sup>. A mortgage transfers the ownership of an asset from the debtor to the creditor on condition that the ownership would be re-transferred upon satisfaction of the debt secured by it<sup>863</sup>. A charge, on the other hand, does not transfer ownership of an asset, but the grant of a charge ensures that a specific asset would be available to satisfy a claim of a creditor<sup>864</sup>. A pledge involves the transfer of possession of an asset to a creditor by way of security<sup>865</sup>. These security interests are also complemented by liens, which arise by operation of law rather than through agreement between parties<sup>866</sup>. All of these security interests therefore involve the transfer of a proprietary right in an asset as security for payment of a debt or other obligation<sup>867</sup>. The need for there to be a proprietary right has therefore meant that conditional sales and other title retention devices, together with hire-purchase agreements and lease options have been considered to fall outside of the traditional definition of a “*security interest*”, in England, and are only referred to as “*quasi-security*”, contrary to the US where they have now been recognised as forms of security<sup>868</sup>.

Differences also exist between North American jurisdictions and other jurisdictions (whether civil or common law jurisdictions) in relation to retention of title under sale and lease agreements<sup>869</sup>. In jurisdictions other than those in North America, a debtor is merely considered to hold possession of assets, given that these contracts will be governed by a sale or by a lease respectively. On the other hand, in North America, through Article 9 of the UCC, and through the Canadian Personal Property Security Acts, one would look at the economic substance of a transaction rather than the legal form,

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<sup>861</sup> Cohen (n 685) 176 – 177.

<sup>862</sup> Roderick J Wood, *The Definition of Secured Creditor in Insolvency Law* (Banking & Finance Law Review, Vol 25, 2010) 343; Goode (n 749) 5; Röver (n 843) 37 – 38.

<sup>863</sup> Wood (n 862) 343.

<sup>864</sup> *ibid.*

<sup>865</sup> *ibid.*

<sup>866</sup> *ibid.*

<sup>867</sup> *ibid.*

<sup>868</sup> Though certain Courts in Canada have begun to view conditional buyers as having an equitable interest in the goods being subject to a conditional sale. See: Wood (n 862) 343 – 345.

<sup>869</sup> Goode (n 741) 48; Goode (n 749) 6.

and therefore in such cases one would still be considered as holding a “*security interest*” over such assets, rather than holding mere possession of that particular asset<sup>870</sup>.

In the US, bankruptcy creditors are typically divided into three groups: secured, preferred and unsecured creditors<sup>871</sup>. Secured creditors are those creditors whose debts are secured by a ‘lien’, which can either be consensual liens (which arise with agreement of third parties, and are generally just referred to as “*security interests*”, and prior to the UCC were referred to as “*chattel mortgages*” when these referred to consensual liens over personal property, and “*mortgages*” when these referred to liens over real property); statutory liens (which become operative by operation of law); and judicial liens (which arise due to there being court action, and which may also include “*pre-judgment*” attachments or garnishees)<sup>872</sup>. Preferred creditors are creditors who the law grants a preference such as employees who may have been due wages, and expenses in relation to the administration of an estate (with these being governed by the US Bankruptcy Code)<sup>873</sup>. Unsecured creditors are those creditors which do not rank and who therefore share *pari passu* amongst themselves<sup>874</sup>.

Article 9 UCC adopts the “*principle of unity*” for security in movable property in that there is only one type of personal “*security interest*” which may be granted, and this irrespective of the type of asset over which such interest would be granted<sup>875</sup>. This means that under the provisions of Article 9 UCC the particular relationship between a debtor and a creditor is regulated under the terms of the particular agreement giving rise to the “*security interest*”, and all types of security interests (whether retention of title clauses, security transfers of title, financial leases provided by way of security, and assignment of receivables for purposes of security) are considered to fall under and be regulated by the same provisions on “*security interests*”<sup>876</sup>.

Though in the US the Bankruptcy Code is a federal statute, it is state law which determines a number of matters, such as: the existence of property interests, how liens

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<sup>870</sup> This approach has also been adopted in New Zealand and in Australia; Goode (n 741) 48; Goode (n 749) 6; Röver (n 843) 45.

<sup>871</sup> Patrick J Borchers, *Choice of Law Relative to Security Interests and Other Liens in International Bankruptcies* (The American Journal of Comparative Law, Vol 46, 1998) 167.

<sup>872</sup> *ibid* 167 – 168.

<sup>873</sup> *ibid* 168.

<sup>874</sup> *ibid*.

<sup>875</sup> Röver (n 843) 44 – 45.

<sup>876</sup> *ibid*.

are constituted, perfected and their order of priority<sup>877</sup>. Nevertheless the promulgation of the UCC has brought about substantially similar laws amongst all of the states in the US, with the basic premise being that “*the law of commercial transactions should not change substantially from state to state*”<sup>878</sup>. Article 9 of the UCC therefore regulates how a security interest “*attaches*” and how this can be “*perfected*”<sup>879</sup>.

Whilst the concept of having a “*mortgage*” is alien to Civil Law jurisdictions, these jurisdictions typically allow immovable property to be “*hypothecated*”, whereby the debtor remains in possession of the immovable, whilst the creditor’s interests are registered in the public register relative to the said asset<sup>880</sup>. In most Civil Law jurisdictions hypothecs are the means through which creditors seek to protect their rights over immovables. Hypothecs rank highly, though they generally remain subject to privileged claims, which are generally established by virtue of law (and are hence not subject to negotiation with regard to nature and form between the debtor and the creditor), and which may need to be registered in the particular jurisdiction in order to take effect<sup>881</sup>.

Furthermore, one of the main forms of security in relation to movables in civil law jurisdictions, similar to common law jurisdictions, is that of the possessory pledge, whereby movables are placed in the possession of the creditor, who may dispose of the said asset in the event of the debtor not fulfilling the obligations being secured by the asset granted to the creditor on pledge, as security<sup>882</sup>. A pledge gives a creditor a proprietary right (i.e. a right *in rem*) over the particular asset being pledged in his favour<sup>883</sup>. The disadvantage of this type of security, however, is that the pledged asset cannot be made use of by the debtor, and therefore it is unlikely that equipment or stock and inventories are given to the creditor on pledge<sup>884</sup>. Another problem with the possessory pledge is that it may be cumbersome for a creditor to store such items, given that the element of possession by the secured party is required<sup>885</sup>. Furthermore, the fact that the debtor needs to part with possession in order for the pledge to be constituted,

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<sup>877</sup> See: Borchers (n 871).

<sup>878</sup> *ibid* 168 – 170.

<sup>879</sup> *ibid* 169.

<sup>880</sup> Drobnič (n 755) 55; Drobnič (n 829) 174.

<sup>881</sup> Drobnič (n 829) 175.

<sup>882</sup> Drobnič (n 755) 55; Drobnič (n 829) 173.

<sup>883</sup> Drobnič (n 755) 57.

<sup>884</sup> *ibid* 55.

<sup>885</sup> *ibid*.

can prove problematic for the debtor since it may limit the debtor's ability to carry out its day to day operations and function properly and profitably<sup>886</sup>.

In light of the limitations brought about by the need of "*possession*" by certain security interests (particularly over movables), different legal systems have sought to create other forms of "*non-possessory security*", thus eliminating the limitations seen above<sup>887</sup>. The two main approaches adopted in different jurisdictions therefore have been that of the "*non-possessory pledge*", and that of "*ownership as a form of security*"<sup>888</sup>.

Different legal systems vary in their approach as to what assets may be provided as non-possessory security<sup>889</sup>. Most Civil law jurisdictions limit non-possessory security through their "*numerus clausus*" doctrine, in virtue of which non-possessory security may only be granted if specific statutes exist and outline how such non-possessory security is to be granted<sup>890</sup>. On the other hand the general rule in Anglo-Saxon systems is that all assets may be granted as non-possessory security<sup>891</sup>.

In establishing the non-possessory pledge, where applicable, legislators have extended the provisions of possessory pledges to intangibles, such as accounts receivable, with the requirement of "*possession*" being instead replaced by the requirement that the debtor is to be notified of the pledge, thereby replacing the "*publicity*" element discussed above<sup>892</sup>. Examples of laws which regulate the registered non-possessory pledge can be found in the Dutch Civil Code of 1992 and the Quebec Civil Code of 1994<sup>893</sup>. The notion of a non-possessory pledge has therefore also allowed the pledging of intangibles as collateral, with the requirement of notification of the underlying debtor being sufficient in order for the pledge to take effect<sup>894</sup>.

In France specific laws in relation to non-possessory pledges over specific assets have been enacted, with specific legislation existing for each of the following: enterprises; automobiles; farm equipment and crops; industrial equipment; goods in warehouses; certain raw materials and industrial products; equipment and commercial furniture of

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<sup>886</sup> *ibid.*

<sup>887</sup> *ibid* 56.

<sup>888</sup> *ibid* 57.

<sup>889</sup> Drobnig (n 829) 178.

<sup>890</sup> *ibid*; Goode (n 741) 54.

<sup>891</sup> *ibid.*

<sup>892</sup> Drobnig (n 755) 55 – 56.

<sup>893</sup> *ibid* 57; Reservation of title is also recognised in both the Netherlands as well as Quebec, see: Drobnig (n 755) 57.

<sup>894</sup> Drobnig (n 755) 60.

hotels; petroleum stocks; films; and the right to exploit software<sup>895</sup>. Though some of these special statutes cater for the granting of all forms of credit, other types are limited specifically for providing security in relation to the acquisition of the respective collateral itself, whereby the assets acquired through the credit provided are pledged as security in favour of the financing entity (i.e. acquisition financing)<sup>896</sup>. On the other hand, in Germany non-possessory pledges are available for only three specific assets, being agricultural tenants' inventory; agricultural fruits; and overseas cables<sup>897</sup>.

The second form of "*non-possessory security*" is through the use of "*ownership*" structures. The French refer to this as "*propriété sûreté*"<sup>898</sup>. According to Drobnič there are three major forms of "*ownership as security*", with these being the "*reservation of ownership*", the "*hire purchase*" and the "*security transfer of ownership*"<sup>899</sup>. The reservation of title acts as security for a seller's claim for the purchase price (together with any other obligations which a buyer may have towards a seller)<sup>900</sup>.

The rights of a secured party in non-possessory security are much wider than those of a pledgee, with this being primarily due to the fact that the concept of "*ownership*" has not originally been used for the purpose of providing security, and therefore the secured party has rights which are more akin to that of an owner, though there is a general tendency to seek to restrict the ownership rights when assets are given under ownership, as security<sup>901</sup>.

In Germany security interests are regulated along the "*principle of multiplicity*" whereby different types of security interests are available for different types of assets<sup>902</sup>. Movables are generally secured through the grant of pledges (whether of the movable thing itself, or of any rights or receivables thereon)<sup>903</sup>. Another possibility under German law is that of granting the usufruct to a creditor, with this giving rights over the asset to the creditor<sup>904</sup>. It is also possible for certain ownership rights to be retained by a creditor by way of security over the purchase price or also over additional debts which

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<sup>895</sup> *ibid* 58.

<sup>896</sup> *ibid*.

<sup>897</sup> *ibid*.

<sup>898</sup> *ibid*.

<sup>899</sup> Drobnič (n 829) 174; Drobnič (n 755) 58.

<sup>900</sup> Drobnič (n 755) 58.

<sup>901</sup> *ibid*; See also Drobnič (n 755) for further examples.

<sup>902</sup> Röver (n 843) 46.

<sup>903</sup> *ibid*.

<sup>904</sup> *ibid* 46 – 47.

may be agreed to between the parties<sup>905</sup>. German law also caters for the provision of security in movables through the transfer of ownership (which may be over movables, rights or receivables) – in such case though the secured creditor is considered to be the owner of the particular asset, he may only sell such asset in case of a default by the debtor<sup>906</sup>.

On the other hand in Germany immovables are typically secured through non-accessory land mortgages whereby immovables are given as security under a mortgage, with this being “*non-accessory*” in light of the fact that this security exists independently of whether a debt continues to be in existence or otherwise<sup>907</sup>. On the other hand it is also possible to have an accessory land mortgage (referred to as the “*hypothek*”)<sup>908</sup>.

This Section has illustrated the importance of security interests to financing parties, but also the vast differences which exist in the way in which security interests come into existence and operate within different jurisdictions. Section 7.2 will show that the Basel Accords discard most of the security interests which apply in different jurisdictions, and ignore the vast differences which apply in relation to security interests which may protect creditors in different jurisdictions.

### **7.1.2 Netting and Set-Off on Insolvency**

Another important credit risk mitigation technique is that of “*On-Balance Sheet Netting*” of mutual amounts due on insolvency between a borrower and a lender. Close-out netting and set-off on insolvency is also a fundamental concept embraced by the International Swaps and Derivatives Association (“**ISDA**”) whereby all contracts under a Master Agreement can be closed-out and netted, with this serving to protect creditors, whilst also acting as a limit to potential systemic risks which could otherwise arise in the financial system<sup>909</sup>.

There may be various transactions between borrowers and lenders: borrowers might have deposits and other funds held with banks, apart from outstanding loans and borrowings. The role of netting is such that cherry-picking on insolvency of a borrower is avoided by ensuring that banks and other creditors would be able to net assets held by the borrower with the said creditor, against liabilities due from the borrower to the

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<sup>905</sup> *ibid* 47 – 48.

<sup>906</sup> *ibid* 48.

<sup>907</sup> *ibid* 48 – 49.

<sup>908</sup> *ibid* 49.

<sup>909</sup> Bergman and others (n 702) 12, 15 – 17.

creditor, with the outstanding net position of the mutual credits then being the final outstanding position due between the creditor and the borrower.

Close-out netting and set-off on insolvency are also important elements in distinguishing between pro-debtor states and pro-creditor states. The difference here is best illustrated by an example: if a financing entity holds 100 on deposit from X, and X has a loan of 100 from the same financing entity, on there being netting and set-off on insolvency the financing entity's exposure will be nil, whereas if netting and set-off is not allowed on insolvency, then the financing entity's exposure will be of 100, since the latter entity will still need to repay the 100 held on deposit, whilst it will only have a *pari passu* claim with all other unsecured creditors over the 100 due to it<sup>910</sup>. Wood has recognised that whereas some legal systems permit such set-off, other jurisdictions such as France reject it (subject to some exceptions)<sup>911</sup>.

According to Wood, “[s]et-off is one of the leading, and most accurate, indicators of pro-debtor or pro-creditor attitudes to insolvency – it is a litmus test of jurisdictions”<sup>912</sup>. Wood considers that this is of “paramount importance” in international financial affairs, and that the “amounts involved are immense and the reduction in exposures achieved by set-off, with resulting reduction in credit costs, and cascade risks threatening the integrity of the financial system, are correspondingly large”<sup>913</sup>. Both set-off and close-out netting reduce credit risk and counterparty risk, and also act as very important systemic risk mitigants and work towards avoiding contagion in the financial system<sup>914</sup>. This principle has also been recognised by the Basel Accords, which allow capital requirements to be calculated on the basis of net, rather than gross credit exposure – though banks are required to show that there is a sound legal basis guaranteeing that close-out netting is enforceable in each relevant jurisdiction<sup>915</sup>.

Wood considers insolvency set-off to be one of the main characteristics which distinguishes certain jurisdictions from others, since the availability of set-off on insolvency means that where this is present, this pays the creditor, whilst in its absence

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<sup>910</sup> Wood 1995(I) (n 15) 97; Jan De Corte, *Enforcement of Close-Out Netting* (May 2015) 14 <<http://ssrn.com/abstract=2437996>> accessed 26 March 2015.

<sup>911</sup> Wood 1995(I) (n 15) 97.

<sup>912</sup> Wood 1995(II) (n 15) 128.

<sup>913</sup> *ibid.*

<sup>914</sup> De Corte (n 910) 14 – 15, 18 – 20.

<sup>915</sup> *ibid* 16.



the debtor benefits<sup>916</sup>. Wood therefore considers there to be a “*straight choice*” which jurisdictions have to make, with this being particularly relevant for financial markets<sup>917</sup>.

Set-off or netting may also be coupled with “*close-out*” provisions which permit a solvent counterparty to terminate a contract under certain conditions (“*early termination*”) and demand immediate payment under the terms of the contract (for the replacement value or for the market value of the contract), or for the repayment of principal in the case of a loan<sup>918</sup>. “*Netting*” and “*set-off*” are conceptually similar, though they need to be distinguished since their legal treatment may vary<sup>919</sup>. Close-out netting refers to the determination and settlement of amounts due between different parties under a single agreement (typically a “*Master Agreement*”) which provides for close out, which means that if a solvent counterparty owes on the netting of the amounts, it will pay immediately, whilst if amounts remain outstanding in favour of the solvent creditor, such entity becomes a creditor for the amount due to it<sup>920</sup>. On the other hand, set-off refers to the netting of individual contracts which individually then provide for netting and close-out and which are then each netted against each other in order to determine the net sums due between the parties<sup>921</sup>. Set-off or netting, particularly on insolvency favours creditors since it ensures that a debt due to a creditor by an insolvent entity can be netted or set-off against amounts which the creditor owed to the same insolvent entity<sup>922</sup>.

This would therefore discharge both claims and ensure that the creditor is being satisfied of amounts due to such creditor notwithstanding that the remaining pool of assets would only have to be shared between other unsecured creditors of the insolvent entity<sup>923</sup>. As a result, set-off and netting encourage commerce because they allow financing parties to provide finance to parties in need if those same entities hold monies or deposits with the financing party. Therefore, by way of example, whilst a company may hold money on account for daily operations and financing of inventories, it may also get money on loan, with the financing entity or bank safe in knowledge that the amounts held with it by the company for its daily operations, can, in the case of insolvency, be set-off against the moneys due to the bank or financing entity.

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<sup>916</sup> Wood 2007 (n 15) 336.

<sup>917</sup> *ibid.*

<sup>918</sup> Bergman and others (n 702) 4; De Corte (n 910) 7 – 8.

<sup>919</sup> Bergman and others (n 702) 5.

<sup>920</sup> Bergman and others (n 702) 5; De Corte (n 910) 11 – 12.

<sup>921</sup> Bergman and others (n 702) 5.

<sup>922</sup> Wood 1995(II) (n 15) 128.

<sup>923</sup> *ibid.*

A distinction can be drawn between jurisdictions which are English-based, as against Franco-Latin jurisdictions<sup>924</sup>. Typically, in English-based countries set-off is restricted between solvent parties, but compulsory on insolvency<sup>925</sup>. Pro-creditor systems therefore allow creditors to protect themselves on default by allowing *ex ante* contractual agreements that permit the solvent counterparty to close out contracts and set off obligations<sup>926</sup>. On the other hand in Franco-Latin jurisdictions set-off takes place immediately between solvent entities, whilst this is usually prohibited on insolvency (in order to increase a debtor's estate on insolvency particularly by disavowing claims made on the firm through "*cherry picking*" or "*avoidance*")<sup>927</sup>. Therefore from a Franco-Latin perspective, set-off on insolvency is a violation of the "*pari passu*" principle because a creditor who benefits from set-off gets paid in full, as against other creditors whose share from the insolvent estate is limited to the remaining pool of unsecured assets of the debtor<sup>928</sup>. This position has also been taken in light of the fact that whereas an intrinsic element of having a security interest is that of having publicity, which is either obtained through registration, or otherwise through having possession of an object, in the case of a set-off on insolvency there is no prior publicity taking place in order for other creditors to be aware that certain assets of the debtor will not form part of the pool of assets to be shared by all creditors on insolvency of the debtor<sup>929</sup>.

On the other hand, those jurisdictions which do not cater for set-off on insolvency typically only allow set-off to take place if this would have been possible prior to the date of insolvency, and therefore the claims must have been mutual, certain, liquidated and due between both parties prior to the established insolvency date (with this possibly also being affected by a suspect period)<sup>930</sup>. Therefore, if set-off on insolvency cannot take place, a creditor is bound to pay amounts due to the debtor into the pool of assets of the insolvent entity, and then only have a claim as an unsecured creditor together with the rest of the unsecured creditors to the assets found in the said pool<sup>931</sup>. Examples of

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<sup>924</sup> *ibid.*

<sup>925</sup> *ibid.*

<sup>926</sup> Bergman and others (n 702) 6.

<sup>927</sup> Wood 1995(II) (n 15) 128. Wood 1995(II) (n 15) 130 contains a list of some of the States which allow set-off on insolvency – this list includes England, Germany, Italy, Ireland, Switzerland, Canada and the US amongst others; Bergman and others (n 702) 6; De Corte (n 910) 20.

<sup>928</sup> Wood 1995(II) (n 15) 129; Fletcher (n 764) 131.

<sup>929</sup> Wood 1995(II) (n 15) 129.

<sup>930</sup> *ibid* 130.

<sup>931</sup> *ibid* 131.

some states which do not allow set-off on insolvency are the following<sup>932</sup>: Spain, Greece, Portugal, Argentina, Brazil, Chile, Mexico and various other states which formed part of French or Belgian dominions<sup>933</sup>.

Notwithstanding that set-off on insolvency is rejected in some states, there are two main exceptions to the general prohibition to set-off on insolvency, within which set-off on insolvency would still be able to take place<sup>934</sup>. The first of these exceptions is in the instance of there being a current account between parties: the balance on a current account is considered to be one amount due, notwithstanding that this is ascertained through both debits and credits entering into such current account<sup>935</sup>. By way of example, this exception is found in the laws of each of France, Luxembourg, Argentina and Bahrain<sup>936</sup>. The second exception to the restriction on set-off on insolvency is found when there is a transaction set-off: therefore the general rule is that where debts and credits relate to one transaction, then set-off can take place on insolvency in relation to that same transaction<sup>937</sup>.

### **7.1.3 The availability of the trust**

The third major credit risk mitigation technique referred to by Wood is that of there being the availability of the trust. The importance of using trusts arises due to the possibility of one holding title to property as an intermediary for the benefit of the real owner, thereby making such property immune from private creditors of the intermediary, and with this being fundamental for global custodianship and settlement systems<sup>938</sup>. This is also particularly useful for trustees of security interests and trustees of bondholders since property of a debtor can be retained in a security trust for the benefit of a creditor until the debtor's obligations are satisfied<sup>939</sup>.

The trust concept developed in English Common law jurisdictions, though over the past few years a number of civil law jurisdictions have sought to make use of similar concepts in order to reach similar effects<sup>940</sup>. Nevertheless the concept of trusts remains alien to a

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<sup>932</sup> See: Wood 1995(II) (n 15) 131 for a more comprehensive list.

<sup>933</sup> Wood 1995(II) (n 15) 131.

<sup>934</sup> *ibid.*

<sup>935</sup> *ibid.*

<sup>936</sup> *ibid.*

<sup>937</sup> *ibid.*

<sup>938</sup> Wood 2007 (n 15) 336.

<sup>939</sup> *ibid.*

<sup>940</sup> Such as the 2007 amendments to the French Civil Code which introduced the concept of "*fiducie*" in Article 2011 et seq of the French Civil Code, and similar amendments to the laws of Luxembourg which had been introduced in 2003; See: Max Ganado, "Trusts and Other Fiduciary

number of Civil law jurisdictions, with this limiting the structuring possibilities which banks and financing parties may have when operating within these jurisdictions. The reduction of credit risks which these entities may seek to achieve may therefore vary depending on whether entities operate within jurisdictions which cater for the possibility of using trusts or otherwise.

## **7.2 Credit Risk Mitigation in the Basel Accords**

Though the Basel Accords seek to reduce the risks which “*internationally-active banks*” face, this is done through a transnational regulatory law which ignores the differences in credit risks which these entities face and which vary from one jurisdiction to another. There is therefore no consideration given as to whether this transnational regulatory law is to operate in a pro-creditor or in a pro-debtor jurisdiction.

Banks and financing entities invariably adopt methods to mitigate their credit risk whenever advancing funds to one of their debtors, thereby ensuring that they will be protected in the event that the debtor defaults on his payments. The Basel Accords also refer to three main “*Credit Risk Mitigation*” techniques<sup>941</sup>: *Collateral*; *Guarantees and Credit Derivatives*; and *Netting* of amounts due. Given that these “*credit risk mitigation*” techniques result in banks and financing entities having their credit risk exposure reduced, the Basel Accords allow a bank’s capital requirements to be reduced due to the reduction in credit risk which such bank would be facing<sup>942</sup>. One should not however assume that the fact that a credit risk mitigation technique would have been adopted, then all the credit risk would have been eliminated, as the particular riskiness of the credit risk mitigant itself will still need to be taken into account, and one will therefore need to look at the quality and risks pertaining to the particular credit risk mitigant itself<sup>943</sup>.

Notwithstanding the above, this thesis argues that one of the main problems of the Basel Accords is that only very limited instruments have been recognised as being capable of reducing a bank’s credit risk. Basel I had only recognised cash, gold, government

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Relationships’ in Max Ganado (ed), *An Introduction to Maltese Financial Services Law* (Allied Publications, 2009) 155; James Koessler, *Is There Room for the Trust in a Civil Law System? The French and Italian Perspectives* (March 2012) 7 – 12 <<http://ssrn.com/abstract=2132074>> accessed 9 October 2015; Hiroyuki Wantanabe, “*Trusts without Equity*” and *Prospects for the Introduction of Trusts into European Civil Law Systems* 189, 192 <<http://win-cls.sakura.ne.jp/pdf/23/20.pdf>> accessed 9 October 2015.

<sup>941</sup> Wood (n 1) 632.

<sup>942</sup> Deloitte (n 853) 4.

<sup>943</sup> Wood (n 1) 632.

securities and securities issued by multilateral development banks, as being “*eligible collateral*” for the calculation of credit risk<sup>944</sup>. This eligibility criteria was widened by Basel II as described below.

The applicable credit risk mitigation rules which the Basel Accords apply today vary according to whether a bank adopts a “*Standardised approach*” or an “*IRB approach*”<sup>945</sup>. For the purposes of this Section specific focus will be made on collateral and guarantees (as opposed to netting of amounts due). It suffices to say however that the Basel Accords allow risk weights to only be applied on a bank’s net exposure where legally enforceable netting arrangements apply<sup>946</sup>.

In terms of the Basel Accords, in order for credit risk mitigation measures to be considered in the calculation of its capital requirements, banks must ensure that the documentation used is legally binding and enforceable in all relevant jurisdictions<sup>947</sup>. Banks would also be required to review the legal position to ensure continuing enforceability, and have clear and robust procedures for the timely liquidation of collateral should the need arise<sup>948</sup>.

The different credit mitigation rules which apply to banks which adopt the Standardised approach and banks which adopt an IRB approach are described in further detail below. One must however also point out that a recent report published by the EBA has highlighted how the credit risk mitigation framework in the CRR (and which is generally reflective of the Basel Accords) requires a higher degree of clarity and that this should be the subject of a comprehensive reform (particularly in order to avoid regulatory

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<sup>944</sup> Slaughter and May, *The New Basel Capital Accord: A Guide to the Main Provisions* (3<sup>rd</sup> edn, September 2004) 42

<[http://www.slaughterandmay.com/media/39266/the\\_new\\_basel\\_capital\\_accord\\_-\\_a\\_guide\\_to\\_the\\_main\\_provisions\\_-\\_third\\_edition.pdf](http://www.slaughterandmay.com/media/39266/the_new_basel_capital_accord_-_a_guide_to_the_main_provisions_-_third_edition.pdf)> accessed 3 October 2014.

<sup>945</sup> Articles 107 and 143 of the CRR set out the criteria as to when the different approaches are to apply.

<sup>946</sup> Goldman Sachs, Latham & Watkins, *Regulatory Capital Requirements for European Banks: Implications of Changing Markets and a New Regulatory Environment* (July 2009) 91 <<http://lw.com/presentations/regulatory-capital-requirements-for-european-banks>> accessed 10 October 2014.

<sup>947</sup> Wood (n 1) 639; Slaughter and May (n 944) 42; Allen & Overy, *Capital Requirements Directive IV Framework – Collateral: Funded Credit Risk Mitigation in the Banking Book* (Allen & Overy Client Briefing Paper 5, January 2014) 4, 7 <<http://www.allenoverly.com/SiteCollectionDocuments/Capital%20Requirements%20Directive%20IV%20Framework/Collateral%20Funded%20credit%20risk%20mitigation%20in%20the%20Banking%20book.pdf>> accessed 12 October 2014.

<sup>948</sup> Wood (n 1) 639; Slaughter and May (n 944) 42; Allen & Overy (n 947) 4.

arbitrage and to ensure a consistent application of this framework across different jurisdictions)<sup>949</sup>.

### 7.2.1 Standardised Approach:

#### 7.2.1.1 Credit Risk Mitigation Techniques for Collateral

There are two approaches to collateral as a credit risk mitigation technique in the Basel Accords: a “Simple Approach” and a “Comprehensive Approach”<sup>950</sup>.

It is to be noted that not all collateral is considered as collateral which can mitigate credit risk for the purposes of the Basel Accords, in view of the list of “*eligible financial collateral*” being limited to specific financial instruments (which are described in further detail below). Furthermore, in order for the collateral to be able to be considered as an appropriate credit risk mitigant for the purposes of the Basel Accords, this cannot have a material positive correlation with the credit quality of the counterparty<sup>951</sup>. Article 194(4) of the CRR states that “*the degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be too high.*”

A bank or financing entity subject to the Basel Accords must also have the right to liquidate or take legal possession of the particular asset provided as collateral, whilst also having clear and robust procedures for the timely liquidation of collateral on a default or on the insolvency of the obligor<sup>952</sup>. The bank must also ensure that it takes all necessary action to maintain the collateral<sup>953</sup>. Furthermore, where collateral is held through a custodian, it must take reasonable steps to ensure that the custodian segregates the collateral from its own assets, in order to ensure that the insolvency of a custodian does not adversely affect the rights of the particular bank or financing entity<sup>954</sup>.

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<sup>949</sup> European Banking Authority, *Report on the Credit Risk Mitigation (CRM) Framework* (19 March 2018) 7 – 8, 18 <<https://www.eba.europa.eu/documents/10180/2087449/EBA+Report+on+CRM+framework.pdf>> accessed 21 March 2018.

<sup>950</sup> Deloitte (n 853) 4; Goldman Sachs, Latham & Watkins (n 946) 92; Wood (n 1) 638 – 639.

<sup>951</sup> Basel II (n 264) para 123; Basel IV (n 354) para 124; Goldman Sachs, Latham & Watkins (n 946) 93; Wood (n 1) 639; Slaughter and May (n 944) 42.

<sup>952</sup> Basel II (n 264) para 124; Basel IV (n 354) para 140; Wood (n 1) 639; Slaughter and May (n 944) 42 – 43; Allen & Overy (n 947) 5.

<sup>953</sup> Wood (n 1) 639; Slaughter and May (n 944) 42; Allen & Overy (n 947) 7.

<sup>954</sup> Basel II (n 264) para 126; Basel IV (n 354) para 143; Slaughter and May (n 944) 43; Allen & Overy (n 947) 5, 7.

According to the CRR, for collateral to be eligible for recognition, the eligible assets relied upon must be sufficiently liquid and their value over time must be sufficiently stable<sup>955</sup>.

#### 7.2.1.1.1 Simple Approach

The Simple Approach is generally a continuance of the regime originally introduced by Basel I, and is meant for those banks which do not have the expertise or capacity to adopt the Comprehensive Approach<sup>956</sup>.

The Simple Approach is a “*substitution method*” whereby the risk weight of the collateral is substituted for the risk weight of the counterparty<sup>957</sup>. The risk weight is however subject to a general floor of 20% in light of the fact that it is considered that there will always be some risk attached to the collateral or the collateral provider<sup>958</sup>. This 20% floor represented a departure from the Basel I regime, which did not have such a floor attached to it, with this also being subject to some exceptions such as when the collateral is provided in cash, or when collateral consists in debt securities issued by sovereign states<sup>959</sup>.

Not all assets are considered to be “*eligible financial collateral*” (and hence allowing for a reduction in a bank’s capital requirements due to the bank being considered to be subject to less credit risk)<sup>960</sup>. In the Simple Approach used by banks adopting the Standardised approach, only the following assets are considered to be “*eligible financial collateral*”<sup>961</sup>:

- Cash on deposit with the lending bank;

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<sup>955</sup> Article 194(3) of the CRR; Allen & Overy (n 947) 5. Though Article 194(10) of the CRR required the EBA to develop regulatory technical standards to specify “*what constitutes liquid assets and when asset values can be considered as sufficiently stable*”, the EBA has considered that these requirements are already covered, “*explicitly or implicitly*” throughout the CRR, and has consequently argued that the obligation imposed on it pursuant to Article 194(10) of the CRR should be deleted. See: EBA (n 949).

<sup>956</sup> Article 194(3) of the CRR; Allen & Overy (n 947) 5.

<sup>957</sup> Deloitte (n 853) 4; Goldman Sachs, Latham & Watkins (n 946) 92; Wood (n 1) 639 – 640; Slaughter and May (n 944) 44; Allen & Overy (n 947) 7 – 8.

<sup>958</sup> Goldman Sachs, Latham & Watkins (n 946) 92; Wood (n 1) 639 – 640; Slaughter and May (n 944) 44.

<sup>959</sup> Allen & Overy (n 947) 8; Slaughter and May (n 944) 44.

<sup>960</sup> Goldman Sachs, Latham & Watkins (n 946) 93.

<sup>961</sup> It should here also be highlighted that though the “*eligible financial collateral*” is limited to the list provided, both in the Basel Accords and the CRR, limited consideration is also given to mortgages given over residential property as well as over commercial immovable property. This however only affects the “*risk weighting*” given to a particular exposure, and does not allow immovable property generally to be used as collateral. See: Articles 124 – 126 of the CRR.

- Gold;
- Rated debt securities (which need to have a rating of BB- or higher in the case of sovereign debt; and BBB- or higher in the case of debt securities issued by banks, securities firms and corporates);
- Senior, unrated debt securities issued by a bank if listed on a recognised exchange, and all other debt securities issued by a bank if these are rated BBB- or higher;
- Equities (including convertible bonds) included in a main index; and
- UCITS/ mutual funds, the price of which is quoted daily and only where such UCITS/ fund invests in the above instruments<sup>962</sup>.

In the Simple Approach, collateral needs, as a minimum, to be provided for the lifetime of the exposure, and cannot be for a shorter period than the exposure in order for this to be considered as “*eligible financial collateral*”<sup>963</sup>. Collateral needs to be marked to market and revalued at least every six months<sup>964</sup>. Furthermore the risk weight applicable to the collateral should at least be equal than or less than the risk weight of the exposure<sup>965</sup>.

One can therefore here see that the types of assets available to be considered as “*eligible collateral*” are very limited such that only the aforementioned items are considered as providing collateral for the purposes of the calculation of the capital adequacy of the bank or the particular financing entity. This applies notwithstanding that from a transactional point of view a bank may have been very comfortable entering into a particular transaction in light of other collateral which may have been provided to it (and notwithstanding that any such assets provided as collateral are not listed in the aforementioned list).

#### 7.2.1.1.2 Comprehensive Approach

The aim of the Comprehensive Approach is to better reflect the mitigation in risks due to the effect of collateral<sup>966</sup>. In the Comprehensive Approach, the value of the collateral is deducted from the risk exposure before assigning the risk weight to such exposure, though the value of the collateral is also subject to “*haircuts*” in order to cater for the

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<sup>962</sup> *ibid*; Wood (n 1) 638 – 639; Slaughter and May (n 944) 43.

<sup>963</sup> Slaughter and May (n 944) 44; Allen & Overy (n 947) 8.

<sup>964</sup> Slaughter and May (n 944) 44; Allen & Overy (n 947) 7.

<sup>965</sup> Slaughter and May (n 944) 44.

<sup>966</sup> *ibid* 45.



risks and changes which may apply to such collateral, particularly upon realisation of such asset on liquidation or in a foreclosure scenario<sup>967</sup>.

These “*haircuts*” may either be pre-defined by the regulator (the “*Standard Supervisory Haircuts*”) (referred to as “*supervisory volatility adjustments*” in the CRR) or alternatively estimated by the bank itself (the “*Own-Estimates Methodology*”) (referred to in the CRR as the “*Own Estimates Volatility Adjustments*”), and are considered to be essential in light of the number of risks (such as fluctuations in value, correlations of the collateral with the debtor, enforceability, exchange rate mismatches, and others) to which the collateral may be subject<sup>968</sup>.

The Standard Supervisory Haircuts are applied according to established calculations depending on the type of collateral, the issuer’s creditworthiness and the maturity of such collateral<sup>969</sup>. On the other hand, in the Own-Estimates Methodology, banks are required to develop internal models, and calculate the Loss Given Default of such collateral<sup>970</sup>.

Similar to the Simple Approach, in the Comprehensive Approach there are also limitations on what can be considered to be “*eligible financial collateral*”<sup>971</sup>. The only assets which are considered as “*eligible financial collateral*” here are the following:

- Those assets considered to be “*eligible financial collateral*” under the Simple Approach;
- Equities not included in a main index but listed on a recognised exchange; and
- UCITS/ mutual funds which invest in the above-mentioned equities<sup>972</sup>.

Therefore, as seen above, under both approaches the Basel Accords only consider very limited assets as “*eligible financial collateral*”, with very strict restrictions as to how and when these can apply. This results in an ambiguous situation whereby any other asset provided as collateral to financing entities which are subject to the Basel Accords, whatever its value, is ignored by both the Simple Approach and by the Comprehensive

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<sup>967</sup> Deloitte (n 853) 4, 6; Goldman Sachs, Latham & Watkins (n 946) 92; Wood (n 1) 640 – 641; Slaughter and May (n 944) 45; Allen & Overy (n 947) 7, 9.

<sup>968</sup> Deloitte (n 853) 4, 6; Wood (n 1) 640 – 641; Slaughter and May (n 944) 45 – 46.

<sup>969</sup> Deloitte (n 853) 7; Allen & Overy (n 947) 9.

<sup>970</sup> Deloitte (n 853) 7.

<sup>971</sup> Goldman Sachs, Latham & Watkins (n 946) 93.

<sup>972</sup> *ibid*; Wood (n 1) 638 – 639; Slaughter and May (n 944) 43.

Approach, notwithstanding that a bank may have security interests over these particular assets.

#### **7.2.1.2 Guarantees**

Guarantees and credit derivatives are also considered as techniques through which credit risk can be reduced in terms of the Basel regime, given that these also act in reducing a bank's risk. Though the Basel Accords and the implementing laws regulate both guarantees and credit derivatives, for the purposes of this thesis the main focus will be on guarantees (though most of the arguments made here should similarly also apply in relation to credit derivatives). The reason for focusing specifically on guarantees and not on credit derivatives is that a guarantee provides security to a creditor in the same way as a debtor does, either through providing assets as collateral or alternatively by being bound as an obligor together with the debtor for the benefit of the creditor.

In order for guarantees to act as a mitigant of credit risk for banks adopting the Standardised approach, they must constitute direct, explicit, irrevocable and unconditional claims on the protection provider, whilst the bank's supervisor must be satisfied that the bank fulfils certain minimum operational conditions relating to its risk management processes<sup>973</sup>. Furthermore, protection must be explicitly limited to and provided for specific exposures or a pool of exposures, whilst documentation must be legally binding and may not contain any clause permitting a protection provider to unilaterally increase the effective cost of cover due to the deteriorating credit quality of exposures<sup>974</sup>.

On there being a default by an obligor, a bank should be able to pursue a guarantor for outstanding exposures, without first needing to take legal action against the obligor<sup>975</sup>. The Basel Accords further state that a guarantor may, on being pursued for monies due, be obliged to either make one lump sum payment of all monies due, or may alternatively assume future payment obligations of the borrower<sup>976</sup>.

Should a guarantee only cover parts of the amounts due, such as only covering the principal sums due, then uncovered payments should be treated as unsecured, and capital relief will therefore only be afforded to the secured portion of the exposure<sup>977</sup>.

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<sup>973</sup> Goldman Sachs, Latham & Watkins (n 946) 94; Wood (n 1) 632 – 634; Slaughter and May (n 944) 47.

<sup>974</sup> *ibid.*

<sup>975</sup> Goldman Sachs, Latham & Watkins (n 946) 94; Slaughter and May (n 944) 47.

<sup>976</sup> Goldman Sachs, Latham & Watkins (n 946) 94; Wood (n 1) 632 – 634.

<sup>977</sup> Goldman Sachs, Latham & Watkins (n 946) 94; Slaughter and May (n 944) 47.

Thus, the risk weights to be applied will be as follows: the protected part of an exposure will be assigned the risk weight of the protection provider, whilst the unprotected part will be assigned the risk weight of the underlying obligor<sup>978</sup>.

The recognised eligible protection providers in the Basel Accords are sovereign entities, public sector entities, banks and securities firms, together with other entities rated A- or better (including credit protection provided by parent, subsidiary, or affiliate companies). In order to be considered as eligible protection providers, these entities should also have a lower risk weighting (i.e. being less risky) than that of the borrower<sup>979</sup>.

The Basel Accords therefore only recognize very limited eligible protection providers, and this notwithstanding that it can be argued that guarantees should be encouraged even if the guarantor is, for example, an unrated corporate having the same risk weighting of the borrower, as this would still be of benefit to a bank given that the bank gets a double cover (meaning that it can seek payment from either of the debtor or the guarantor). The risk weight afforded to the exposure under this regime (whereby the risk is calculated on the basis of the guarantor's risk weighting), does not take into account the double cover which the bank is getting through there being such guarantee.

### **7.2.2 Internal Ratings-Based Approach**

Banks adopting an IRB approach may generally use the same credit risk mitigation techniques available to banks adopting the Standardised approach (i.e. collateral; guarantees and credit derivatives; and on-balance sheet netting)<sup>980</sup>. However banks using the IRB approach are only permitted to adopt the Comprehensive Approach outlined above, and may not make use of the Simple Approach<sup>981</sup>. The credit risk mitigation techniques adopted, will work towards reducing the Loss Given Default factor used by banks adopting the IRB approach in calculating their capital requirements (though for guarantees, banks may alternatively adjust their Probability of Default; whilst for on-balance sheet netting the Exposure at Default would be affected)<sup>982</sup>.

Furthermore, banks using the Advanced IRB approach may make use of their own estimates for establishing the Loss Given Default of sovereign, bank and corporate

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<sup>978</sup> Goldman Sachs, Latham & Watkins (n 946) 96; Wood (n 1) 632 – 634.

<sup>979</sup> Goldman Sachs, Latham & Watkins (n 946) 95; Wood (n 1) 632 – 634; Basel II (n 264) para. 195.

<sup>980</sup> Goldman Sachs, Latham & Watkins (n 946) 99.

<sup>981</sup> *ibid*; Slaughter and May (n 944) 52.

<sup>982</sup> Goldman Sachs, Latham & Watkins (n 946) 99; Slaughter and May (n 944) 50.

exposures, provided that the necessary supervisory approvals would have been obtained, whilst if the Foundation IRB approach is used, banks will have to make use of the Loss Given Default values provided by the supervisor<sup>983</sup>.

#### **7.2.2.1 Collateral**

The eligible financial collateral permitted for banks using the IRB approach is wider than that accepted for banks using the Standardised approach, and consists of:

- All financial collateral permitted to be used as eligible financial collateral by banks using the Standardised approach;
- Receivables;
- Residential and Commercial Real Estate; and
- Other collateral, if permitted at national discretion, if there exists a liquid market for disposal of the collateral in an expeditious and economically efficient manner, and if there exists a publicly available market price for the collateral. In such instance banks will need to apply the same standards applicable to commercial and residential real estate, and therefore:
  - a) the bank must have a first priority security interest;
  - b) the documentation must include a detailed description of the collateral and the manner and frequency of revaluation;
  - c) the bank must have internal credit policies and procedures setting out the types of collateral and the appropriate amount of collateral relative to the exposure; and
  - d) in the case of inventories, periodic revaluation and physical inspection is to take place<sup>984</sup>.

The position adopted by the CRR is such that under the IRB approach, physical collateral other than immovable property and leasing may also be considered as eligible forms of collateral subject to detailed eligibility requirements<sup>985</sup>. Though Article 199(8) of the CRR required the EBA to “*disclose a list of types of physical collateral for which institutions*

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<sup>983</sup> Goldman Sachs, Latham & Watkins (n 946) 99; Wood (n 1) 634 – 637.

<sup>984</sup> Goldman Sachs, Latham & Watkins (n 946) 101; Wood (n 1) 644 – 647; Slaughter and May (n 944) 50 – 51.

<sup>985</sup> Article 199 of the CRR; Allen & Overy (n 947) 5 – 7.

*can assume that the conditions referred to in points (a) and (b) of paragraph 6 are met”, the EBA has since come to the conclusion that “[c]urrently, there are no types of physical collateral for which institutions can automatically assume that [such] conditions ... can be met”<sup>986</sup>.*

#### **7.2.2.2 Guarantees**

Banks adopting the IRB approach may, for the purposes of guarantees and credit derivatives, generally follow the same approach afforded to banks adopting the Standardised approach<sup>987</sup>.

The range of eligible guarantors under the Foundation IRB approach is the same as that for banks adopting the Standardised approach, though entities that are internally rated and associated with a Probability of Default equivalent to A- or better may also be recognised here<sup>988</sup>.

A bank using the Advanced IRB approach may reflect the credit risk mitigation effect of guarantees by either adjusting the Probability of Default, or the Loss Given Default estimates<sup>989</sup>. However the adjusted risk weight must not be less than that of a comparable direct exposure to the guarantor<sup>990</sup>. Under the Advanced IRB approach there are no limits on the range of eligible guarantors (as long as the bank has clearly specified criteria as to what type of guarantor it will accept, and provided that the guarantee is evidenced in writing, non-cancellable, is in force, and is legally enforceable against the guarantor)<sup>991</sup>.

#### **7.2.2.3 Specialised Lending**

The IRB approach (under both the Basel Accords and the CRR<sup>992</sup>) also sets out a regime for specialised lending exposures with these having been differentiated from the general

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<sup>986</sup> European Banking Authority, *EBA Publishes List for the Calculation of Capital Requirements for Credit Risk* (EBA, 2 July 2014) <<https://www.eba.europa.eu/-/eba-publishes-lists-for-the-calculation-of-capital-requirements-for-credit-risk>> accessed 30 April 2018. Article 199(6)(a) and (b) of the CRR refer to the requirements of there being liquid markets, evidenced by frequent transactions taking into account the asset type, for the disposal of the collateral in an expeditious and economically efficient manner; and there being well-established, publicly available market prices for the collateral.

<sup>987</sup> Goldman Sachs, Latham & Watkins (n 946) 102.

<sup>988</sup> Wood (n 1) 634 – 637.

<sup>989</sup> *ibid.*

<sup>990</sup> *ibid*; Slaughter and May (n 944) 54.

<sup>991</sup> Basel II (n 264) para. 307.

<sup>992</sup> The proposals which are being put forward in the CRR II suggest further amendments to the specialised lending regime, whereby loans which fall within this category would benefit from a

corporate asset class<sup>993</sup>. The specific exposures referred to here are those exposures towards an entity which would have been created purposely in order to finance or operate physical assets, with the lender typically being given a substantial degree of control over the particular assets as well as over the particular income streams which would be generated by the said physical assets<sup>994</sup>. In the cases falling within this regime, one considers that the particular asset which would have been financed would be provided as collateral for the benefit of the financing party, and that the same asset would be helping in the production of income which would be used to repay the specific lending exposure. Five different types of specialised lending have been identified (Project Finance; Object Finance; Commodities Finance; Income Producing Real Estate; and High Volatility Commercial Real Estate), with the rules which apply to each type of specialised lending being generally similar to each other.

The introduction of a specialised lending regime sought to overcome the shortcomings of the Basel Accords' treatment of the financing of different assets by differentiating between corporate exposures and other forms of lending which merited a special approach due to their particular nature. Different treatment is afforded since the risk assessment here does not depend on the corporate risks of a borrower, but depends on the income stream generated by the particular assets in relation to which credit is

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reduced risk weight, meaning that the capital adequacy regulations would be taking cognisance of certain collateral which would be provided here, and the lower risks which a bank would face. Though this would be another positive step, the current proposal still does not take into consideration the different insolvency laws and types of security interests which exist in different jurisdictions. It is also ambiguous as to why the effects of collateral are taken into consideration when considering the risk weighting of assets (rather than give further consideration to this as a credit risk mitigation tool). See: CRR II (n 93) 402.

<sup>993</sup> Wood (n 1) 643 – 644; Basel Committee on Banking Supervision, *Working Paper on the Internal Ratings-Based Approach to Specialised Lending Exposures* (October 2001) 8 – 9 <[http://www.bis.org/publ/bcbs\\_wp9.pdf](http://www.bis.org/publ/bcbs_wp9.pdf)> accessed 8 October 2014.

<sup>994</sup> European Banking Authority, *Consultation Paper: Draft Regulatory Technical Standards on Assigning Risk Weights to Specialised Lending Exposures under Article 153(9) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)* (EBA/CP/2015/09, 11 May 2009) 4, 6 <<https://www.eba.europa.eu/documents/10180/1068081/EBA-CP-2015-09+CP+on+Assigning+RWs+to+Specialised+Lending+Exposures.pdf>> accessed 12 May 2015.

granted, and the structure of a particular transaction<sup>995</sup>. Further, the value of the asset being financed acts as a risk mitigant, rather than as a primary source of repayment<sup>996</sup>.

The exposures considered in the specialised lending regime have the following characteristics:

- (a) the economic purpose of the loan is to acquire or finance an asset;
- (b) the cash flow generated by the purchased asset, and given as collateral to the bank, is the borrower's sole or almost exclusive source of repayment;
- (c) the exposure represents a significant liability in the borrower's capital structure; and
- (d) the primary determinant of credit risk being the variability of the cash flow generated by the collateral, rather than the independent capacity of the borrower<sup>997</sup>.

It has been recognised that in specialised lending particular adjustments need to be made since exposures vary from corporate exposures in that both the Probability of Default and the Loss Given Default increase simultaneously on there being a loss on the value of the collateral (though the mathematical calculations justifying this are beyond the scope of this study)<sup>998</sup>.

The Basel regime considers loans which have been classified as specialised lending to have unique loss distribution and risk characteristics: these loans are considered to be subject to greater risk volatility, with banks possibly being the subject of high default rates and high loss rates<sup>999</sup>. Furthermore, banks using the IRB approach may use different internal risk rating criteria for these loans, and may therefore treat these loans separately in other internal risk management processes<sup>1000</sup>.

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<sup>995</sup> Basel Committee on Banking Supervision (n 993) 1; Wood (n 1) 633 – 634; Thieffry Gilles, *The Impact of Basel II on Commodity Trade Finance: a legal perspective* (Journal of International Banking Law and Finance, Vol. 19, Issue 10, 2004) 3 – 4; Malloy Michael P., *International Project Finance: Risk Analysis and Regulatory Concerns* (Transnational Lawyer, Vol. 18, Issue 1, 2004) 89 – 90; European Banking Authority (n 1152994) 4, 6.

<sup>996</sup> Thieffry (n 995) 3 – 4.

<sup>997</sup> Basel Committee on Banking Supervision (n 993) 1 – 2; Malloy (n 995) 99 – 100.

<sup>998</sup> Basel Committee on Banking Supervision (n 993) 10.

<sup>999</sup> *ibid* 1.

<sup>1000</sup> *ibid*.

The BCBS, established three approaches which may be used by banks adopting an IRB approach when dealing with specialised lending, being the “*supervisory slotting criteria approach*” (originally referred to as the “*basic approach*”), the “*foundation*” approach, and the “*advanced*” approach<sup>1001</sup>.

The “*supervisory slotting criteria approach*” is characterised by there being supervisory estimates being available in light of the fact that a bank would not meet the requirement for the internal estimation of the Probability of Default under the corporate foundation approach. Banks will therefore map their internal rating grades into five supervisory rating categories (classified into “*strong*”, “*good*”, “*satisfactory*”, “*weak*” and “*default*”), with this mapping taking place in accordance with defined criteria on the following items: “*Financial Strength*”, “*Political and Legal Environment*”, “*Transaction Characteristics*”, “*Operating Risk*”, “*Asset Characterisation*”, “*Strength of Sponsor*”, and “*Security Package*”<sup>1002</sup>. Other than for high-volatility commercial real estate, banks will apply a risk weight of 70% to those items classified as “*strong*”, 90% to those classified as “*good*”, 115% to those classified as “*satisfactory*”, 250% to those classified as “*weak*” and 0% for those classified as “*default*”, whilst at national discretion supervisors may allow 50% for “*strong*”, and 70% for “*good*” if the exposure matures in less than two and a half years, or if the supervisor determines that underwriting or other risk characteristics are substantially stronger<sup>1003</sup>.

Under the “*foundation approach*”, banks that meet the requirements for the estimation of the Probability of Default may use the foundation approach for corporate exposures to derive risk weights here (other than for some differences with regard to high volatility commercial real estate)<sup>1004</sup>.

On the other hand in the “*advanced approach*”, banks able to meet rigorous standards would be able to calculate the Probability of Default, the Loss Given Default and the Exposure at Default, in the same way as these are applied for corporate exposures<sup>1005</sup>. Those banks which receive approval from their regulators to use this advanced

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<sup>1001</sup> *ibid* 6 – 8; See also: Basel II (n 264) para. 249 – 251.

<sup>1002</sup> Basel Committee on Banking Supervision (n 993) 6 – 8, 18 – 27; Thieffry (n 995) 3 – 4; See also: Cornford Andrew, *Basel 2 and the Availability and Terms of Trade Finance* (Global Commodities Forum, Palais des Nations, Geneva, 22 – 23 March 2010) <[http://unctad.org/sections/wcmu/docs/GCF2010\\_Cornford.eng.PDF](http://unctad.org/sections/wcmu/docs/GCF2010_Cornford.eng.PDF)> accessed 12 November 2015; Wood (n 1) 633 – 634; Basel II (n 264) Annex 6.

<sup>1003</sup> Cornford (n 1002); Goldman Sachs, Latham & Watkins (n 946) 45.

<sup>1004</sup> See also: Basel II (n 264) para. 250.

<sup>1005</sup> Basel Committee on Banking Supervision (n 993) 6 – 8; Wood (n 1) 633 – 634.



approach gain considerable advantages over other banks: given that these banks could use historical portfolio data, they will effectively be required to hold substantially less capital than other banks, putting the banks subject to the “*advanced approach*” at an advantage<sup>1006</sup>.

The effect of assets being held as collateral under the “*advanced approach*” (in the specialised lending regime) is therefore such that since the particular asset is used as security which can be sold or which can help in exposures being recouped on default, this helps in reducing the Loss Given Default of a bank on there being any such default (and which therefore means that whilst the Probability of Default and Exposure at Default remain the same, the collateral provided reduces the exposures/ losses of the bank upon there having been a default)<sup>1007</sup>.

### ***7.3 The Effect of the Credit Risk Mitigation Techniques adopted by the Basel Accords***

It has been argued that the Basel Accords are not generally concerned with ordinary commercial bank secured lending (other than for the specific consideration given under the specialised lending regime used by banks adopting the IRB approach), and that the only types of collateral which attract special reduced risk weights are those types of collateral used in financial markets and which have near cash status<sup>1008</sup>.

The type of collateral considered as “*eligible collateral*” for the purposes of credit risk mitigation measures has long been considered as being too restrictive, and continues to be viewed as such notwithstanding the rules applicable to specialised lending exposures<sup>1009</sup>. There is limited recognition of security interests on various assets (particularly those assets which are given as collateral when long term financing is required), and no distinction is made as to where the collateral is placed and which jurisdiction one would seek to enforce a security interest in (and the ease of enforceability of such collateral, particularly in an insolvency scenario).

In light of the restrictive classification as to what can be considered as a credit risk mitigation technique for the purposes of the Basel Accords, it comes as no surprise that

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<sup>1006</sup> CorporateJetInvestor, *Basel III and Business Aviation* (August 2012) 8 <<http://www.corporatejetinvestor.com/wp-content/uploads/2012/10/CJI-2012-Basel-III-and-business-aviation.pdf>> accessed 15 October 2014.

<sup>1007</sup> See also: CorporateJetInvestor (n 1006) 8.

<sup>1008</sup> Wood (n 1) 637 – 638.

<sup>1009</sup> Lloyds TSB plc (n 572) 7.

recent statistics published in the EU show that well over 90% of credit is considered to be “*uncollateralised*” for the purposes of the CRR<sup>1010</sup>.

The Basel Accords seem to have adopted this restrictive position due to the current “*eligible collateral*” being easy to value on a daily basis<sup>1011</sup>. Another reason for Basel’s restricted choice of “*eligible collateral*” may also be due to the assumption that in most of the advanced jurisdictions there is special legislation which gives effect to the contract terms of a financial market security interest (regardless of insolvency freezes, priority or unsecured preferential creditors, restrictions on sale without a court order, and other matters which affect security interests)<sup>1012</sup>.

The effect of non-financial collateral in the IRB approach is very limited, and in Wood’s words, this “*shows that the Basel Committee did not have a very high view of the use of collateral risk reduction*”, particularly since the cost saving made here will be very limited<sup>1013</sup>. The reason Wood attributes to this is that most secured transactions do not provide for topping up the collateral should this fall in value, with other reasons being that governing security interests in many countries are very poor, with there also increasingly being freezes on organisations, together with the inability of banks to check that the collateral was being monitored<sup>1014</sup>. Those assets which are not considered to be “*eligible*” therefore give rise to higher capital requirements, placing bank financing at a disadvantage as against non-bank institutions which are not subject to the Basel regime<sup>1015</sup>.

Though under the IRB approach the Basel Accords extend the range of eligible financial collateral further than under the Standardised approach, this still remains very limited and subject to national discretion. Furthermore, in areas where eligible financial collateral has been extended further (such as in relation to residential and commercial

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<sup>1010</sup> EBA (n 949) 21.

<sup>1011</sup> Wood (n 1) 637 – 638.

<sup>1012</sup> *ibid*.

<sup>1013</sup> *ibid* 644 – 647; The limitations which apply in relation to physical collateral had also been highlighted to the BCBS by industry groupings such as the Aviation Working Group: Aviation Working Group, *New Basel Capital Accord/ Consultative Document/ Aviation-Specific Comments* (Letter to the Basel Committee on Banking Supervision, 30th May 2001) <<http://www.bis.org/bcbs/ca/aviworgro.pdf>> accessed 1<sup>st</sup> May 2017; Aviation Working Group, *New Basel Capital Accord/ Third Consultative Document/ Aviation-Specific Comments* (Letter to the Basel Committee on Banking Supervision, 31 July 2003) <<https://www.bis.org/bcbs/cp3/aviworgro.pdf>> accessed 1 May 2017.

<sup>1014</sup> Wood (n 1) 644 – 647.

<sup>1015</sup> Lloyds TSB plc (n 572) 14.

real estate<sup>1016</sup>) the differences in the underlying laws still fail to be considered and are ignored by the regulations, meaning that a mortgage which can very easily be enforced in a pro-creditor jurisdiction is being given the same value and effect as a first priority hypothec in a pro-debtor jurisdiction where it might take years for actual realisation of that collateral to take place for the benefit of the secured party.

Furthermore, the adoption of the Advanced IRB approach is conditional on the availability of data held by the bank going back five years in order to calculate the Probability of Default, and seven years of data for Loss Given Default and Exposure at Default – however the obtainment of this data has proved problematic for banks to obtain (particularly in light of the fact that data would take seven years to obtain, during which time the said bank would need to satisfy higher capital requirements in light of the impossibility of adopting an Advanced IRB approach)<sup>1017</sup>.

A further criticism was aimed at the eligibility of collateral focused on the absence of recognition of certain “*imperfectly secured*” transactions, also classified as “*quasi-security interests*”: though quasi-security interests can provide a good alternative to security interests and provide sufficient leverage over goods which would have been financed, they are not recognised as eligible collateral for the purposes of the Basel Accords<sup>1018</sup>.

Though the establishment of the specialised lending regime is a step in the right direction, this remains undeveloped. Notwithstanding that the use of specialised lending criteria allows for proper consideration of collateral where assets are financed by using the Advanced IRB approach, this remains limited to very few banks in that only those banks which do have experience in the field can make use of historical portfolio data. Furthermore, the use of the specialised lending regime remains dependent upon risks which are analysed by banks and without there being a deeper consideration as to what security a bank actually does have, and what inhibitions and limitations it may face in seeing to make use of that security, particularly on insolvency. It has also been stated that in practice, notwithstanding the provisions of specialised lending on adopting the IRB approach, great emphasis is still placed on the counterparty, rather than on the product or performance risk of an asset being financed, and to any credit risk mitigating

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<sup>1016</sup> It has been argued that this has mainly been extended further solely in light of political pressures particularly in the U.S.; See: Thomas Cottier, John H. Jackson, Rosa M. Lastra, *International Law in Financial Regulation and Monetary Affairs* (OUP, 2012) 225.

<sup>1017</sup> Cornford (n 1002).

<sup>1018</sup> Thieffry (n 995) 4 – 5.

effects which might be in place<sup>1019</sup>. Consequently, the specialised lending criteria is still treated with skepticism<sup>1020</sup>.

The criteria used by the Basel Accords in relation to the supervisory slotting approach also demonstrates the lack of depth which the Basel Accords enters into upon considering security interests and the rights of creditors on the insolvency of a debtor. On establishing the criteria for each of the specialised lending sectors, banks need to determine the existence of a number of requirements (with these varying from one category of specialised lending to another), such as: a “*favourable and stable regulatory environment over the long term*”; “*enforceability of contracts, collateral and security*”; the possibility of there being assignment of contracts and accounts; there being a “*first perfected security interest*”; there being a “*strong*” covenant package; there being a “*perfected first lien*”; “*assignment of rents*”; determining that the “*jurisdiction is favourable to repossession and enforcement of contracts*”; and the lender having effective control (such as through there being a “*first perfected security interest*”) <sup>1021</sup>. These generic terms however ignore the vast differences which exist between different states, the pro-debtor or pro-creditor bias jurisdictions may have, and how these considerations affect lenders. Consequently it is here argued that notwithstanding the adoption of similar laws across different jurisdictions, the risks which different banks face will still vary depending on whether they operate in pro-creditor or in pro-debtor jurisdictions.

The above also shows that there are marked differences in the risk management techniques adopted by the industry (on a microeconomic, transactional level, when taking collateral from their borrower) and in the risk management techniques imposed on banks and financing parties by the Basel Accords (and which adopt a macroeconomic risk management approach, and which are primarily based on capital ratios and with very limited recognition of risk management techniques adopted on a transactional level by financing entities). These different risk management techniques invariably give rise to a mismatch in that certain transactions which might be considered as low risk for a financing entity when advancing credit, might be considered to be very high risk for the purposes of the Basel Accords (particularly if the collateral provided is not considered to be “*eligible financial collateral*”). This mismatch however continues to encourage the

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<sup>1019</sup> Cornford (n 1002).

<sup>1020</sup> Thieffry (n 995) 14.

<sup>1021</sup> Basel II (n 264) 281 – 294.

industry to resort to regulatory arbitrage in order to avoid the restrictions which arise from the Basel Accords.

### 7.3.1 Long-Term Financing

A brief comment on long-term financing is also warranted in light of the effects of the Basel Accords, which is seemingly leading to a shift in long-term financing to nonbank entities.

Long-term financing is generally required for major projects, and is considered to be one of the main elements of banking, whereby banks borrow from the public for the short-term (through deposits from the public), and lend out money for the medium-term or longer-term projects at higher interest rates. The Basel Accords however treat long-term financing with skepticism<sup>1022</sup>. Banks active in long-term financing face liquidity issues since banks cannot rely on those of its assets which it has given out as loans for long-term financing purposes – particularly since recalling loans is bound to affect the public's confidence in the bank. Furthermore banks are negatively affected by the lack of proper consideration of the collateral which they hold given that long-term financing is typically secured by the particular project or asset being financed as explained above.

Though banks have historically been the main providers of long-term investment, they have scaled back their involvement here, particularly in light of Basel III, the EBA rules, and the rising cost of funding, resulting in a situation where there are very few banks which still finance long-term projects<sup>1023</sup>. The new stability ratios introduced by Basel III, particularly, do not favour long term investment<sup>1024</sup>. This is surprising, however, given that most long-term projects, such as major infrastructure projects, certain concession agreements, or even power purchase agreements, tend to result in lengthy and stable revenue streams<sup>1025</sup>.

Long-term financing is thus placed at a disadvantage over short-term financing. Though a report which has been prepared for the European Commission and which sought to assess the impact of the CRR on the access to finance for business and long-term

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<sup>1022</sup> Wood (n 1) 664.

<sup>1023</sup> Reviglio Edoardo, *Global Perspectives for Project Financings: Financing Future Infrastructure – EU 2020 and Long Term Financing, Regulatory Aspects* (Joint EC-EIB/EPEC Private Sector Forum, Brussels, 6 June 2012) <<http://www.bei.org/epec/resources/presentations/psf-06062012-presentationnotes-cdp.pdf>> accessed 20 October 2014.

<sup>1024</sup> *ibid.*

<sup>1025</sup> *ibid.*

investments<sup>1026</sup>, has sought to downplay the effects of the CRR by arguing that in the long-term the reduction in bank financing will be minimal, it is pertinent to note that the said report has also highlighted that bank financing only provided for 65.9% of infrastructure deals in 2014 (i.e. down from 82.7% in 2007) due to a shift towards non-bank investors<sup>1027</sup>. The said report also noted how banks have specifically noted that the CRR has led them to focus on projects having a shorter tenor<sup>1028</sup>. It has here also been reported that “[m]ost banks feel that the CRR has unnecessarily penalized the long-term risk at the core of infrastructure lending”, such that banks “are being required to place more capital toward projects in a sector which has not been prone to particular risky lending or frequent default” (with banks also reporting that this has led them to focus also on projects offering higher returns, which therefore presumably means that there has also been a shift in focus towards financing riskier projects)<sup>1029</sup>.

### 7.3.2 Basel IV – Taking One Step Back

In June 2016 the BCBS issued a consultative document<sup>1030</sup> which sought to limit the use of the IRB approach. The proposals which have been put forward by this consultation document and the consequent standards which have been promulgated by the BCBS<sup>1031</sup> have been informally termed as “Basel IV” by the industry. This consultation document proposed to limit the use of the IRB approach given that it argued that “[o]ne of the lessons from the financial crisis is that not all credit risk exposures are capable of being modelled sufficiently reliably or consistently for use in determining capital requirements”, and that there has been “significant unwarranted variability in RWA [risk weighted assets] calculated under the IRB approaches”<sup>1032</sup>.

Though the BCBS proposal was criticized by major players, such as by the European Parliament which sought to argue that the use of internal models is of particular importance for European banks and sought to emphasize that “the right to use internal

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<sup>1026</sup> London Economics, *Impact of the Capital Requirements Regulation (CRR) on the Access to Finance for Business and Long-Term Investments: Final Report* (European Commission, April 2016) <[https://ec.europa.eu/info/sites/info/files/160505-crr-study\\_en.pdf](https://ec.europa.eu/info/sites/info/files/160505-crr-study_en.pdf)> accessed 8 July 2017.

<sup>1027</sup> *ibid* 12, 144, 150, 155, 177.

<sup>1028</sup> *ibid* 12, 144, 176.

<sup>1029</sup> *ibid* 176.

<sup>1030</sup> BCBS, *Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches* (Bank for International Settlements, March 2016, Issued for Comment by 24 June 2016) <<http://www.bis.org/bcbs/publ/d362.pdf>> accessed 26 April 2017.

<sup>1031</sup> Basel IV (n 354).

<sup>1032</sup> BCBS (n 1030) 2.

*models should be preserved*<sup>1033</sup>, the standards promulgated by the BCBS (which are to be implemented by 1<sup>st</sup> January 2022) established that the Advanced IRB approach would no longer be applicable for exposures to equities, to banks and other financial institutions, and to large and mid-sized corporates (which have consolidated revenues above €500 million). Consequently banks will only be able to use the Standardised approach, or the Foundation IRB approach (but not in relation to equities) in order to apply credit risk mitigation measures<sup>1034</sup>.

This thesis argues that this is a step backwards since this would further enhance the use of a Standardised approach which does not distinguish between the risks which are actually faced on financing a particular counterparty. Limiting the use of IRB approaches means that banks cannot apply capital requirements according to case-specific risks. This also limits the possibility of catering for domestic embeddedness through the use of bank models. Limiting the use of IRB approaches will mean that capital requirements will continue to be even more standardised, without there being any analysis whatsoever taking place as to what actual risks a bank faces, and what capital is to be retained in relation to specific risks. The severe consequences which this may give rise to (including increased regulatory arbitrage and shifts to non-regulated entities) can also be seen from papers which have been produced by industry-specific entities<sup>1035</sup>.

## 7.4 Conclusion

Part IV of this thesis has shown how, though the Basel Accords seek to provide a transnational regulatory law to reduce systemic risks, these international standards ignore the main risk mitigating factors which the same subjects of the Basel Accords adopt on a transactional basis. Whilst on entering into a transaction banks and financing entities seek to limit their risks by ensuring that proper collateral is in place, the “eligible

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<sup>1033</sup> European Parliament (n 7) Resolution 16.

<sup>1034</sup> Basel IV para 34. See also: BCBS, *High-Level summary of Basel III Reforms* (BIS, December 2017) <[https://www.bis.org/bcbs/publ/d424\\_hlssummary.pdf](https://www.bis.org/bcbs/publ/d424_hlssummary.pdf)> accessed 23 February 2018.

<sup>1035</sup> Aviation Working Group, *Comment Letter on the Second Consultative Document – Standards/Revisions to the Standardised Approach for Credit Risk, issued December 2015* (Letter addressed to the Basel Committee on Banking Supervision, 10<sup>th</sup> March 2016) <<http://awg.aero/assets/docs/Basel-Committee-AWG-submission-on-second-consultative-document-10.pdf>> accessed 26 May 2017; Aviation Working Group, *Proposed Changes to the Rules for Regulatory Capital – Aircraft Backed Loans* (Letter addressed to the Bank for International Settlements, 14 October 2016) <<http://awg.aero/assets/docs/Basel-AWG-study-on-aircraft-backed-loans-14-October-2016.pdf>> accessed 26 May 2017; Aviation Working Group, *Revised Rules Capital Requirements – Unique Features and Data Supporting Low LGDs for Aircraft-Backed Loans* (December 2016) <<http://awg.aero/assets/docs/Basel-unique-features-and-data-supporting-low-LGDs-for-aircraft-backed.pdf>> accessed 26 May 2017.

*financial collateral*" which is accepted by the Basel Accords is only limited to very specific liquid assets. Furthermore, Basel IV will be further restricting the use of the IRB approach, which to-date provides much needed flexibility in order to address the concerns which have been raised in this Part IV.

Moreover, though the Basel Accords seek to provide a transnational framework in order to reduce systemic risks, the Basel Accords also discount the underlying national laws within which the Basel Accords operate. As highlighted in Chapter 6, though there are vast differences between pro-debtor and pro-creditor jurisdictions, these considerations are not given any importance in the Basel Accords, which assume that all financing entities (irrespective of the jurisdiction within which they operate) start off from the same level of risk and that consequently the Basel Accords will have the same effects across all jurisdictions.

It has also been shown how there have only been few harmonization initiatives in relation to both the laws of insolvency and the laws which regulate security interests, such that even in regional groupings such as the EU, national laws continue to vary substantially.

In Chapter 9 it will therefore be argued that the Basel Accords could provide the appropriate mechanism for laws on insolvency and security interests across different jurisdictions to be drawn closer together by providing for lower capital requirements for those financing entities which operate in pro-creditor jurisdictions (in light of the lower risks to which they are subject). This will provide an incentive for states to update their laws to pre-defined standards or specific model laws. It will be argued that the style adopted by the CTC, as reviewed in Chapter 8 of this thesis, could therefore be used as a model for this purpose.



**PART V – THE CAPE TOWN CONVENTION AS A MODEL  
FRAMEWORK, CONCLUSIONS, AND PROPOSALS**

## Chapter 8: The Cape Town Convention as a Model for the Basel Accords

### 8.1 Introduction

The CTC has been considered as one of the most successful transnational law instruments, with this being attributed to the continuous focus on economic analysis by its proponents. Wool, on arguing that further importance needs to be given to law and economics in harmonisation of private law, has stated that the economic benefits which were envisaged to be obtained through the CTC is the reason why the CTC and the Aircraft Protocol “*have obtained such broad support*”<sup>1036</sup>.

The CTC was promulgated with the involvement of each of the international community, the relevant regulators, as well as industry participants, and the CTC’s promoters did not ignore fundamental questions on which there is no harmonisation (such as laws on insolvency and security interests) but instead sought to create international instruments which are recognised across borders and which prevail over national laws. The economic analysis adopted has therefore meant that each of the parties which are affected by the CTC have incentives to see that the instrument adopted by the international community works.

Furthermore, the CTC was adopted through an instrument which is considered as “*binding*” and which gives rise to international rights and obligations between states, rather than relying on soft-laws which are dependent on individual states for their adoption and enforcement. The CTC also managed to bring about harmonisation of laws related to insolvency and security interests in a specific field of law, with this being done in light of each of the international community, the relevant regulators and the industry being involved in the promulgation of the CTC.

States also have incentives to update their laws on insolvency and security interests, since entities situate therein benefit from “*Cape Town Discounts*” when seeking finance from export credit agencies (“**ECAs**”), for high value mobile equipment which they would be acquiring (as will be discussed throughout this Chapter). These Cape Town Discounts are provided in light of the reduction in capital adequacy requirements which ECAs are required to maintain as a result of the lower risks faced due to the implementation of pro-creditor model laws on insolvency and security interests as proposed by the CTC.

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<sup>1036</sup> Wool 2003 (n 5) 390.

This thesis therefore argues that the model adopted by the CTC can provide a framework through which different underlying laws on insolvency and security interests in different jurisdictions can be approximated through a transnational law. This would also allow financing entities to give proper consideration to the credit risks they face, and with this being properly reflected in the capital retained by such entities.

For this purpose this Chapter seeks to explore the main elements of the CTC and how it sets out to reach its goals, in order for this to be contrasted with the main elements of the Basel Accords which have been considered throughout this thesis.

## ***8.2 Main Elements of the Cape Town Convention***

### **8.2.1 Background to the CTC**

The CTC<sup>1037</sup> and its associated Aircraft Protocol<sup>1038</sup> were concluded in November 2001, at a Diplomatic Conference held at Cape Town, under the auspices of UNIDROIT, which had been the prime mover for the Convention, together with the International Civil Aviation Organization (“ICAO”)<sup>1039</sup>. The CTC and the Aircraft Protocol have been very successful and currently have 77 and 73 contracting states respectively (apart from the EU which has signed the CTC and the Aircraft Protocol as a regional economic integration organisation)<sup>1040</sup>. One can therefore note, from the outset, that the CTC and the Aircraft Protocol did not rely on a soft-law mechanism, but rather sought to make use of a Treaty which would have binding obligations upon the signatories to this Treaty (and its relative Protocols).

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<sup>1037</sup> The CTC has three separate Protocols, which respectively deal with: airframes, aircraft engines, and helicopters; railway rolling stock; and space assets. Nevertheless on the date hereof only the Aircraft Protocol has been brought into force.

<sup>1038</sup> Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Cape Town, 16 November 2001) (Aircraft Protocol).

<sup>1039</sup> Roy Goode, *Transnational Commercial Law and the Influence of the Cape Town Convention and Aircraft Protocol* (Canadian Business Law Journal, Vol 50, 2011) 186 – 187; Aviation Working Group, *Practitioners’ Guide to the Cape Town Convention and the Aircraft Protocol* (The Legal Advisory Panel of the Aviation Working Group, November 2012) 6 <<http://www.awg.aero/assets/docs/Practitioner-Guide-November-2012.pdf>> accessed 10 April 2015.

<sup>1040</sup> Goode (n 1039) 187; UNIDROIT, *Convention on International Interests in Mobile Equipment (Cape Town, 2001) – Status* <<http://www.unidroit.org/status-2001capetown>> accessed 12 August 2018; UNIDROIT, *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment – Status* <<https://www.unidroit.org/status-2001capetown-aircraft>> accessed 12 August 2018.

It has therefore been stated that the “*highest priority*” for the Aviation Working Group (which represented the industry in the drafting process of the CTC), was<sup>1041</sup>:

*to ensure that contracting states would be offered rules that embraced the ‘fundamental principle’ that ‘in exchange for a reduced interest or rental rate, a secured party/ lessor will have the ability upon default to promptly take possession of the subject equipment and, in the case of asset-based debt financing, to convert the equipment into proceeds’, including in insolvency.*

The CTC thus sought to deal with the problem that though manufacturers, lessors and lenders may take security over an aircraft (and with their valuations being based on the predicted future values of that aircraft), a secured party would still be faced with problems in recouping moneys due to it on enforcement if the aircraft were to be situated in a jurisdiction which limits the secured party’s right to enforce, if third party creditors are given priority, or if repossession of the aircraft is delayed due to pro-debtor processes<sup>1042</sup>. Therefore, the CTC was driven by the need to achieve one main goal, which was that of positively impacting on the cost and availability of finance for high-value mobile equipment, particularly since the early drafters of the CTC were convinced that “*the absence of an international legal regimen*” deterred the provision and availability of asset-based finance, and that this could be remedied by a Convention which would govern the validity and enforceability of security interests<sup>1043</sup>. The attainment of economic benefit particularly through increasing the availability and reducing the cost of aviation credit was the central and driving objective of the CTC, with this being the reason as to why the CTC was drafted as a commercially-oriented treaty<sup>1044</sup>. It has therefore been stated that the “*principal objective of the Convention is to facilitate the efficient financing and leasing of mobile equipment*”<sup>1045</sup>.

Though originally the main focus was solely on security interests, and though the initial drafters had promised that the CTC would “*in no way seek to displace national bankruptcy rules*”, it soon became clear that insolvency provisions were essential in order to reach the Convention’s objectives<sup>1046</sup>. The 1998 economic impact assessment

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<sup>1041</sup> Kristin van Zwieten, *The Insolvency Provisions of the Cape Town Convention and Protocols: Historical and Economic Perspectives* (Cape Town Convention Journal, September 2012) 62.

<sup>1042</sup> *ibid* 53.

<sup>1043</sup> *ibid* 70.

<sup>1044</sup> Wool 2012 (n 5) 633, 640, 643.

<sup>1045</sup> Roy Goode, *Convention on International Interests in Mobile Equipment and Protocol thereto on Matters Specific to Aircraft Equipment: Official Commentary* (UNIDROIT, Third Edition, 2013) 13.

<sup>1046</sup> van Zwieten (n 1041) 70.

on the CTC and on the Aircraft Protocol, which set out the necessary conditions for the CTC to achieve economic benefit, therefore also envisaged that the CTC and the Aircraft Protocol would increase the availability of external finance where it would otherwise not have been available, and reduce its cost where available<sup>1047</sup>. This economic impact assessment considered the insolvency provisions of the CTC and the Aircraft Protocol as being the “*litmus test of an asset-based financing*”<sup>1048</sup>.

The CTC sought to address the problem that high unit value equipment regulated by the Convention transcends national borders and is subject to varying legal regimes, making the legal regime regulating them unstable<sup>1049</sup>. Furthermore, aircraft as well as space assets do not operate “*on the ground*” or even on earth, leading different jurisdictions to adopt different approaches to regulating these assets (if regulated at all)<sup>1050</sup>. The main problem faced by financiers therefore was that a security interest taken in one jurisdiction was not recognised in others, and though a security interest might have been taken in a pro-creditor jurisdiction, the particular asset could find itself operating in a pro-debtor jurisdiction which may be relatively hostile to security interests and the exercise of self-help default remedies<sup>1051</sup>.

In 1989 Cuming recommended a “*hands-off*” approach to insolvency, and proposed the establishment of a Convention that would deal with rules of priority and provide for basic default remedies (of seizure and sale) through the use of conflict of law rules, but which would not have dealt with default remedies on insolvency, and which would therefore have remained subject to the specific national insolvency laws<sup>1052</sup>. Though respondents to a survey following the Cuming Report supported the “*inclusion of one substantive rule that would require security interests recognised as created under the proposed convention to be treated as security interests in insolvency proceedings*”, the general view remained that “[w]hile bankruptcy law cannot be ignored, it is completely unrealistic to attempt to influence national bankruptcy law in any significant way through

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<sup>1047</sup> *ibid*; Wool 2012 (n 5) 645, 649 – 650.

<sup>1048</sup> van Zwieten (n 1041) 71.

<sup>1049</sup> Goode (n 1039) 189; Cranston (n 47) 606; Goode (n 1045) 14.

<sup>1050</sup> Goode (n 1039) 189.

<sup>1051</sup> *ibid*.

<sup>1052</sup> Ronald C C Cuming, *International Regulation of Aspects of Security Interests in Mobile Equipment* (UNIDROIT, International Institute for the Unification of Private Law, 1989) <<http://www.unidroit.org/english/documents/1989/study72/s-72-01-e.pdf>> accessed 1 November 2015; van Zwieten (n 1041) 54.

*a Convention (or rules) dealing with the international recognition of security interests in mobile equipment*<sup>1053</sup>.

It was however quickly recognised that what was needed was “*clear and effective rules governing the creation, perfection and priority of security interests*”, and in light of the varying national laws this necessitated the creation of an entirely new security interest in mobile equipment “*possessing the characteristics given by the Convention itself and publicised by registration within an international registration system*” (which would hence start being referred to as the “*international registry*”)<sup>1054</sup>. This became particularly relevant in light of the fact that it had been recognised that the problems caused by the legal framework that governed the treatment of security interests in movables had negatively affected the availability of finance for high-value mobile equipment<sup>1055</sup>.

### **8.2.2 Main Objectives and Principles of the CTC**

The Official Commentary to the CTC listed five key objectives which the CTC and the Protocols sought to achieve, consisting of<sup>1056</sup>: the facilitation of acquisition and financing of mobile equipment by establishing international interests which are recognised in all contracting states; the establishment of a range of basic default and insolvency-related remedies for the benefit of creditors, whilst providing also means of obtaining speedy-relief pending final determination of claims on the merits once there would have been evidence of default; the establishment of an electronic international registry in which international interests are registered, thereby giving notice to third parties whilst allowing creditors to preserve their priority against subsequently registered interests and against unregistered interests and creditors on the insolvency of the debtor; ensuring that the relevant Protocol and the particular industry needs are met; and as a result of these objectives, to give creditors greater confidence in taking decisions to grant credit, whilst enhancing the credit rating of equipment receivables and reducing borrowing costs and credit insurance premiums to the advantage of all interested parties. Therefore as legal certainty is provided through the CTC, financiers’ risks are reduced, leading to lower borrowing costs<sup>1057</sup>.

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<sup>1053</sup> van Zwieten (n 1041) 54.

<sup>1054</sup> Goode (n 1039) 190; van Zwieten (n 1041) 54 – 56; Aviation Working Group (n 1039) 6 – 7.

<sup>1055</sup> van Zwieten (n 1041) 54.

<sup>1056</sup> Goode (n 1045) 15.

<sup>1057</sup> Goode (n 1039) 191.

It has been stated that the “*overriding objective*” of the CTC has been “*to provide an international legal regime which will give proper protection to the interests of secured creditors and thereby increase predictability, reduce risk and lower financing costs, to the benefit of all interested parties*”<sup>1058</sup>. Furthermore, the Aircraft Protocol was adopted not simply to elaborate on the CTC, but, rather, to adapt the CTC to the specific peculiarities of the aviation sector<sup>1059</sup>. This contrasts starkly with the position taken in the Basel Accords, and in other transnational laws and transnational regulatory laws generally, whereby there has been little harmonisation of laws on insolvency and security interests, resulting in the Basel Accords refusing to take cognisance of the underlying insolvency laws and laws on security interests which exist in different jurisdictions and the implications which this may have on financing entities.

It has also been stated by Goode in the Official Commentary to the CTC that the “*five underlying principles*” of the CTC and the Protocols are those of practicality (in reflecting asset-based financing and leasing transactions); party autonomy and contractual freedom; predictability; transparency (by having registration of international interests); and sensitivity to different national legal cultures<sup>1060</sup>.

The CTC and the Aircraft Protocol allow states to make declarations in order to suit their specific needs with this providing signatory states with flexibility in order to be able to cater for certain peculiarities which different states may need to provide for<sup>1061</sup>. The CTC however only permits there to be reservations made by states where this is expressly provided for in the text of the CTC, with this restriction being included in order to seek to have greater uniformity amongst states which adopt the CTC<sup>1062</sup>. This complements the Vienna Convention on the Law of Treaties which states that a state may exclude or modify the legal effect of a specific provision of a Treaty through the deposit of a unilateral reservation on ratifying a particular Treaty<sup>1063</sup>. Given that the CTC

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<sup>1058</sup> *ibid* 191, 193.

<sup>1059</sup> Teresa Rodríguez de las Heras Ballell, *The Accession by Spain to the Cape Town Convention: A First Assessment* (Uniform Law Review, Vol 19 Issue 1, UNIDROIT, 2014) 6.

<sup>1060</sup> Goode (n 1045) 22 – 23.

<sup>1061</sup> Andrew Tetley, *Security Interests in Ships and Aircraft* (New Zealand Law Review, 2006) 702.

<sup>1062</sup> See: Article 56(1) CTC.

<sup>1063</sup> Article 21, Vienna Convention on the Law of Treaties (Vienna, 1969); Eric Lippé, *Are You In or Out? The Impact of Declarations made under the Cape Town Convention/ Aircraft Protocol on Achieving Global Legal Uniformity of Aircraft Financing Laws* (Thesis submitted in partial fulfilment of the degree of Master of Laws, Institute of Air and Space Law, McGill University Montreal, June 2009) 15.  
<[http://digitool.library.mcgill.ca/webclient/StreamGate?folder\\_id=0&dvs=1447519295120~779](http://digitool.library.mcgill.ca/webclient/StreamGate?folder_id=0&dvs=1447519295120~779)> accessed 26 March 2015.

and Protocols are instruments of international law, governed by the Law of Treaties, these are subject to the principle of autonomous interpretation and therefore one should only interpret the CTC and the Protocols in accordance with their specific terms, subject to any declarations which different jurisdictions may have made. Consequently, one cannot apply principles of domestic law when interpreting the said instruments<sup>1064</sup>.

### 8.2.3 Security Interests and International Interests

The success of the CTC may also be attributed to its flexibility – when it was being drafted it had been proposed for the CTC to refer solely to “*security interests*” in mobile equipment (including sales under reservation of title and finance leases), which would have adopted a “*functional approach to security*” similar to that found in Article 9 of the UCC<sup>1065</sup>. It however became clear that European members were not enthusiastic about this approach in light of the freedom of parties to make use of different interests in most European states, with different legal effects, even if serving the same economic function<sup>1066</sup>. Therefore lawyers from continental Europe did not accept that the distinction between security and title reservation was “*formal rather than functional*” and they felt that there were advantages in having different instruments governed by different rules leading to different outcomes<sup>1067</sup>. Furthermore lawyers from continental Europe felt that a functional approach may lead to recharacterisation for tax purposes and this was therefore also a concern which they faced<sup>1068</sup>. The solution which was resorted to was to have the characterisation of the particular agreement being dealt with under the applicable domestic law (and being subject to rules of private international law in the particular jurisdictions)<sup>1069</sup>.

In order for the CTC to apply, the agreement must be a “*security agreement*”, a “*title reservation agreement*”, or a “*leasing agreement*”<sup>1070</sup>. The characterisation of an agreement in one of these three categories is important as the CTC distinguishes between them in that the provisions on security interests are more detailed than the provisions governing title reservation agreements and lease agreements – given that in the latter two categories the secured party is the owner, who should therefore have

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<sup>1064</sup> Goode (n 1045) 23 – 24.

<sup>1065</sup> Goode (n 548) 345; Goode (n 1039) 189 – 190.

<sup>1066</sup> Goode (n 548) 345; Goode (n 1039) 45.

<sup>1067</sup> Goode (n 1039) 190.

<sup>1068</sup> *ibid.*

<sup>1069</sup> Goode (n 1045) 45.

<sup>1070</sup> *ibid* 195; Aviation Working Group (n 1039) 10, 12 – 13.



rights, on default, to terminate the title reservation agreement or the lease agreement, and repossess the asset<sup>1071</sup>.

A unique feature of the CTC is that it establishes “*international interests*”, which give rise to a security interest which has priority over domestic security interests and which applies and takes effect in all contracting states<sup>1072</sup>. The characterisation of international interests in domestic law would however be governed by the specific applicable national law (and therefore a right under a security agreement, a title reservation agreement, or a lease, created through domestic law can be registered as an international interest and be subject to the terms of the CTC regulating international interests)<sup>1073</sup>. The characterisation at national law means that remedies may vary between jurisdictions, depending on the characterisation which national law provides, such that Goode recognised that “*a conditional sale agreement would be treated by a French court as a title reservation agreement but by a New York court as also constituting a security agreement, so that only the Convention provisions governing security agreements apply to it*”<sup>1074</sup>.

The creation of an “*international interest*” however presents a marked difference from having recognition of security interests which would have been created under national law<sup>1075</sup>. The international interest created by the CTC goes further than other Conventions since it creates an interest which “*sits above domestic law*” and which has priority over national security interests<sup>1076</sup>. Therefore rather than harmonising security interests across borders, the CTC, through the creation of the “*international interest*” concept, created an international right which prevails over national law, being enforceable on its own specific terms, whilst also giving rise to specific enforceability possibilities.

The “*international interest*” is described in Article 2(2) of the CTC as follows<sup>1077</sup>:

- (a) granted by the chargor under a security agreement;
- (b) vested in a person who is the conditional seller under a title reservation agreement; or

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<sup>1071</sup> Goode (n 1039) 195.

<sup>1072</sup> Aviation Working Group (n 1039) 10.

<sup>1073</sup> *ibid.*

<sup>1074</sup> Goode (n 1039) 195 – 197.

<sup>1075</sup> Buxbaum (n 687) 330; Tetley (n 1061) 699.

<sup>1076</sup> Tetley (n 1061) 699; Aviation Working Group (n 1039) 10.

<sup>1077</sup> Tetley (n 1061) 699; Article 2(2), Cape Town Convention (n 16); Goode (n 1039) 194; Aviation Working Group (n 1039) 12 – 13.

(c) vested in a person who is the lessor under a leasing agreement.

Furthermore the CTC caters for a very wide definition of a “*security agreement*”, as follows<sup>1078</sup>:

*“security agreement” means an agreement by which a chargor grants or agrees to grant to a chargee an interest (including an ownership interest) in or over an object to secure his performance of any existing or future obligation of the chargor or a third person ....*

International interests are registrable and searchable in a centralised international registry accessible over the internet, with registration securing priority<sup>1079</sup>. Registration in the international registry does not create an international interest or provide proof thereof, but what it does is that it gives public notice of interests which would have been created and thereby it ensures priority against subsequent registered interests and over unregistered interests<sup>1080</sup>. Furthermore, other than the creation of a cross-border international interest concept, the CTC also established rules of priority across borders, a basket of remedies on enforcement (which include self-help remedies), as well as provisions in order to regulate the insolvency of a debtor (and particularly in order to ensure the priority, rights and interests of the holder of an international interest)<sup>1081</sup>.

The rules on priority are straightforward – an international interest ranks in priority to all other interests that are not registered, whilst between interests which would have been registered the rule is that ranking will be dependent upon the time of registration – with those registrations registered first ranking above those which are registered later<sup>1082</sup>. The CTC does not exclude the creation of security interests under national law, but it subordinates them to registered international interests<sup>1083</sup>. All international interests registered before the opening of insolvency proceedings are to be effective on insolvency<sup>1084</sup>.

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<sup>1078</sup> Tetley (n 1061) 700.

<sup>1079</sup> Goode (n 1039) 192, 197 – 199; Aviation Working Group (n 1039) 52 – 53; Goode (n 1045) 76.

<sup>1080</sup> Goode (n 1045) 76.

<sup>1081</sup> Tetley (n 1061) 699.

<sup>1082</sup> *ibid* 700 – 701; Aviation Working Group (n 1039) 19 – 20; Goode (n 1039) 200.

<sup>1083</sup> *ibid* 197.

<sup>1084</sup> *ibid* 192.

#### 8.2.4 Remedies Given by the CTC and by the Aircraft Protocol

The main remedies granted by the CTC start to apply on there being a default by a debtor – which will thus prejudice a creditor or an owner. The CTC lets the debtor and creditor define contractually what they would consider to be a default and what instances would thus allow the creditor to benefit from the remedies granted by the CTC<sup>1085</sup>. Article 11 of the CTC states that the “*debtor and the creditor may at any time agree in writing as to the events that constitute a default or otherwise give rise to the remedies specified in Articles 8 to 10 and 13*”<sup>1086</sup>. Article 11 then further states that where “*the debtor and the creditor have not so agreed, “default”...means a default which substantially deprives the creditor of what it is entitled to expect under the agreement*”<sup>1087</sup>.

The CTC also specifically provides for remedies, which differ depending on the type of international interest granted (depending on whether remedies are granted due to there being a conditional sale or leasing agreement, or whether remedies are granted due to there being a default under a security agreement)<sup>1088</sup>. The CTC also provides a set of default remedies as interim relief (pending final determination of a creditor’s claim) to which a creditor (which is defined as referring to each of a chargee under a security agreement, a conditional seller under a title reservation agreement, and a lessor under a leasing agreement<sup>1089</sup>) is entitled to, upon providing evidence of there being a default<sup>1090</sup>. Furthermore, additional remedies permitted by national law may also be exercised as long as these do not contradict the mandatory remedies provided for in the Convention<sup>1091</sup>.

As explained above, the CTC has been modified and supplemented by the Aircraft Protocol<sup>1092</sup>. The Aircraft Protocol extended the CTC to apply also to outright sales, which are not registrable under the CTC <sup>1093</sup>. Furthermore the Aircraft Protocol also provides default remedies of “*de-registration and export of the aircraft*” on there being a default by a debtor, with the process of de-registration and export taking place automatically without there being any discretion granted to national authorities in

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<sup>1085</sup> Article 11, Cape Town Convention (n 16); Aviation Working Group (n 1039) 105.

<sup>1086</sup> *ibid*; Goode (n 1045) 289 – 290.

<sup>1087</sup> *ibid*.

<sup>1088</sup> Tetley (n 1061) 702.

<sup>1089</sup> Article 1, Cape Town Convention (n 16).

<sup>1090</sup> Tetley (n 1061) 702; Goode (n 1039) 192; Article 13, Cape Town Convention (n 16); Goode (n 1045) 67.

<sup>1091</sup> Tetley (n 1061) 702; Aviation Working Group (n 1039) 106; Article 12, Cape Town Convention (n 16); Goode (n 1045) 66 – 67.

<sup>1092</sup> Goode (n 1039) 192.

<sup>1093</sup> *ibid*.

administering the process (subject to any applicable safety laws and regulations)<sup>1094</sup>. De-registration and export authorisation is granted through an Irrevocable De-Registration and Export Request Authorisation (“**IDERA**”), and the person in whose favour the said IDERA would have been granted by the debtor (or his certified designee) becomes the sole person entitled to procure the de-registration and export of the said aircraft (though any such rights cannot be exercised unless prior ranking creditors would have provided their consent thereto)<sup>1095</sup>. The rationale of the provision of these remedies is in order to remove the aircraft further away from the control of the debtor and for the transfer of such control to the creditor<sup>1096</sup>.

Another main feature of the CTC is that it contains specific provisions regulating the insolvency of a debtor, with this having been considered as an essential element for the CTC to have adopted an economic approach<sup>1097</sup>. Though under the CTC the priority of an international interest does not escape the application of local insolvency laws relating to the avoidance of a transaction as a preference or as a transfer in fraud of creditors, the Aircraft Protocol<sup>1098</sup> allows a state to make one of two declarations relating to insolvency (referred to as “*Alternative A*” (which is the preferred, pro-creditor system, also referred to as the “*hard*” alternative) or “*Alternative B*” (also referred to as the “*soft*” alternative))<sup>1099</sup>. Contracting states making one of these declarations may only make such a declaration in its entirety<sup>1100</sup>. The core insolvency provisions found in the Aircraft Protocol have been described as the “‘*single most significant provision economically*’ of the entire UNIDROIT project”<sup>1101</sup>. As will be seen in Section 8.3, having a debtor-creditor relationship being subject to the Alternative A rules may also result in cheaper financing possibilities due to the lower risks faced by the creditor.

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<sup>1094</sup> *ibid*; Aviation Working Group (n 1039) 100; Article IX, Aircraft Protocol (n 1038); Goode (n 1045) 181, 447 – 452.

<sup>1095</sup> Aviation Working Group (n 1039) 100 – 101, 132; Goode (n 1045) 181.

<sup>1096</sup> Goode (n 1045) 181.

<sup>1097</sup> Tetley (n 1061) 702; van Zwieten (n 1041) 53.

<sup>1098</sup> This approach is also replicated in Article IX of the Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock (Luxembourg Protocol), and in Article XXI of the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets (Space Protocol); van Zwieten (n 1041) 62.

<sup>1099</sup> The Luxembourg Protocol also adds a third “*Alternative C*” which offers a “*middle way*” between Alternative A and Alternative B. Jurisdictions may also opt to make no declaration at all, in which case its existing national insolvency laws will continue to apply; Tetley (n 1061) 703; Goode (n 1039) 193; van Zwieten (n 1041) 57, 62, 63, 69; Aviation Working Group (n 1039) 128; Goode (n 1045) 224 – 225, 458 – 459.

<sup>1100</sup> Goode (n 1045) 225, 459.

<sup>1101</sup> van Zwieten (n 1041) 62; See also: Goode (n 1045) 458.

Alternative A, which is largely based on s.1110 of the US Bankruptcy Code is “*specifically designed to meet the requirements of advanced structured financing, including international capital market financing structures*”<sup>1102</sup>. This offers the highest protection to financiers against local and other unsecured creditors as it obliges the insolvency administrator to cure all defaults (and agree to fully perform in future) within a declared “*waiting period*” (with most states prescribing a thirty or a sixty day period as being the said “*waiting period*”), or alternatively to give up possession of the aircraft (whilst also granting rights of repossession to the creditor) to the holder of an international interest<sup>1103</sup>. When Alternative A applies there is no scope for application of local insolvency provisions relating to claw-back or voidable transaction provisions<sup>1104</sup>. No discretion is given to Court either in relation to the Alternative A remedies and this in order to ensure that financiers and lessors benefit from a clear and unqualified rule<sup>1105</sup>.

In Alternative B, a creditor which holds a registered Convention interest, is given the opportunity to make a “*request*” to the insolvency administrator, and upon receipt of such a request, the insolvency administrator is given a prescribed period (determined by the contracting state) to give notice that it will either cure all defaults (and agree to perform all future obligations under the agreement giving rise to the Convention interest), or alternatively give the creditor the opportunity to take possession “*in accordance with applicable law*”<sup>1106</sup>. It is therefore assumed that repossession under Alternative B will involve some application by the creditor to a Court, and that the applicable law itself may “*require the taking of any additional step or the provision of any additional guarantee*”<sup>1107</sup>. In the event that an administrator fails to respond to a creditor’s request or if it fails to afford the creditor opportunity to take possession of the

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<sup>1102</sup> Goode (n 1045) 225; See also: Tetley (n 1061) 703; Goode (n 1039) 193; van Zwieten (n 1041) 62 – 63, 65; Deepak Reddy, Carlo Vairo and Alexander Hewitt, *Should the UK adopt Cape Town’s Alternative A Insolvency Regime? Lessons from the US and Canada* (Corporate Rescue and Insolvency, December 2014) 237; Aviation Working Group (n 1039) 128 – 129.

<sup>1103</sup> As at time of writing almost all jurisdictions had adopted the “*Alternative A*”, with only Mexico having adopted the “*Alternative B*” approach; Tetley (n 1110) 703; Goode (n 1039) 193; van Zwieten (n 1041) 62 – 63, 65; Reddy, Vairo and Hewitt (n 1102) 237; Aviation Working Group (n 1039) 128 – 129; Goode (n 1045) 225, 459 – 460.

<sup>1104</sup> Tetley (n 1061) 703; van Zwieten (n 1041) 62 – 63.

<sup>1105</sup> Goode (n 1039) 193; van Zwieten (n 1041) 62 – 63.

<sup>1106</sup> van Zwieten (n 1041) 67; Aviation Working Group (n 1039) 131; Goode (n 1045) 229 – 230, 462.

<sup>1107</sup> van Zwieten (n 1041) 67; Goode (n 1039) 193; Goode (n 1045) 229 – 230.

aircraft, then a Court “may” permit the creditor to take possession of the equipment (but subject to any condition which the said Court may impose)<sup>1108</sup>.

### ***8.3 The Aircraft Sector Understanding and Cape Town Discounts***

The Sector Understanding on Export Credits for Civil Aircraft (“ASU”) is an arrangement between certain Organisation for Economic Co-operation and Development (“OECD”) participants, and is found as Annex III to the Arrangement on Officially Supported Export Credits set out by the OECD<sup>1109</sup>. The importance of the ASU has arisen over the past years as export credit financing gained importance, particularly since the financial crisis, as credit from commercial banks and capital markets became more difficult to obtain<sup>1110</sup>.

The importance of this is that it creates a system which provides incentives for jurisdictions to adopt the Alternative A to insolvency, referred to in Section 8.2. Jurisdictions which would have signed up to the Aircraft Protocol to the CTC are required to adopt one of two systems of laws, with clear incentives being given to the adoption of the said Alternative A. This system has encouraged jurisdictions to adopt and implement laws which stand above their local laws on insolvency and security interests, resulting in the harmonisation of laws across jurisdictions. These incentives are provided through the recognition that the adoption of pro-creditor laws will lower the risks of financing parties, and consequently allowing financing to be cheaper. This thesis envisages that similarly the Basel Accords can adopt systems whereby the adoption of pro-creditor laws by jurisdictions would allow the adoption of lower capital

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<sup>1108</sup> van Zwieten (n 1041) 68; Goode (n 1045) 229 – 230.

<sup>1109</sup> Organisation for Economic Co-Operation and Development, *Sector Understanding on Export Credits for Civil Aircraft* (Trade and Agriculture Directorate, Participants to the Arrangement on Officially Supported Export Credits, TAD/PG(2007)4/FINAL) 2 <[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/pg\(2007\)4/FINAL&doclanguage=en](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/pg(2007)4/FINAL&doclanguage=en)> accessed 4 August 2015 (2007 ASU); Organisation for Economic Co-Operation and Development, *Sector Understanding on Export Credits for Civil Aircraft* (Trade and Agriculture Directorate, Participants to the Arrangement on Officially Supported Export Credits, TAD/ASU(2011)1) 1, 4 <[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/asu\(2011\)1&doclanguage=en](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=tad/asu(2011)1&doclanguage=en)> accessed 4 August 2015 (2011 ASU); Organisation for Economic Co-Operation and Development, *Arrangement on Officially Supported Export Credits* (Trade and Agriculture Directorate, Participants to the Arrangement on Officially Supported Export Credits, TAD/PG(2015)7) <[http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=tad/pg\(2015\)7](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=tad/pg(2015)7)> accessed 12 November 2017 (2015 Export Credits Arrangement); Marisa Chan, *New OECD Sector Understanding on Export Credits for Civil Aircraft* (Law and Financial Markets Review, November 2007) 511.

<sup>1110</sup> Dean N Gerber, *The 2011 Aircraft Sector Understanding: Calming the Turbulent Skies* (The Air & Space Lawyer, Vol 24 No 1, 2011) 1.

requirements in light of financing entities operating in such jurisdictions being subject to lower credit risks.

The ASU has been described as a “*Gentlemen’s Agreement*” amongst its participants (though a breach thereof would allow a member to file a claim under the World Trade Organisation’s (“**WTO**”) Dispute Settlement Understanding) and seeks to “*provide a framework for the predictable, consistent and transparent use of officially supported export credits*” for the sale or lease of aircraft and other aircraft related equipment<sup>1111</sup>. The ASU seeks to “*foster a level playing field for such export credits, in order to encourage competition among exporters based on quality and price of goods and services exported rather than on the most favourable officially supported financial terms and conditions*”<sup>1112</sup>.

The ASU establishes “*the most favourable terms*” on which officially supported export credits and favourable financing terms may be provided, and therefore seeks to establish a framework between its participating states, through which these states compete fairly, and thereby seeks to avoid distortion of competition through incentives which such states may grant<sup>1113</sup>.

As will be seen in Chapter 9 to this thesis, one of the proposals which will be made will be that the Basel Accords can be used as an incentive towards harmonisation of laws on security interests and insolvency. The operation of the ASU already adopts this approach (through the use of Cape Town Discounts which are referred to below), and a similar system may be put in place by the Basel Accords to this effect.

The initial agreement between the US and the UK, Germany, France and Spain (being the European countries involved in the manufacturing of Airbus aircraft) was referred to as the “*Large Aircraft Sector Understanding*”, and sought to create a uniform standard for ECA financing<sup>1114</sup>. Though there was no definition of what “*official support*” could be

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<sup>1111</sup> 2007 ASU (n 1109) 2; 2011 ASU (n 1109) 4; 2015 Export Credits Arrangement (n 1109) 5; Lippé (n 1063) 86; Daniel Friedenzohn, *The Aircraft Sector Understanding: New Financing Rules that Reflect the Aviation World of Today* (The Airline Monitor, 2011) 1 <<http://commons.erau.edu/cgi/viewcontent.cgi?article=1002&context=db-aeronautical-science>> accessed 26 March 2015.

<sup>1112</sup> 2007 ASU (n 1109) 2; 2011 ASU (n 1109) 4; See also: 2015 Export Credits Arrangement (n 1109) 5; Gerber (n 1110) 15; Friedenzohn (n 1111) 1.

<sup>1113</sup> 2007 ASU (n 1109) 2; 2011 ASU (n 1109) 4; 2015 Export Credits Arrangement (n 1109) 50; Chan (n 1109) 511.

<sup>1114</sup> Gerber (n 1110) 14; Friedenzohn (n 1111) 1; Aviation Working Group, *2011 Aircraft Sector Understanding – Overview and Summary*, 3 <<http://www.awg.aero/assets/docs/ASU%20PowerPoint%20-%202011.pdf>> accessed 14 September 2015.

provided, it was understood that this included “*government-backed support for an ECA and could take the form of direct credits/financings, interest-rate support, ECA insurance, and guarantees*”<sup>1115</sup>.

In July 2007 certain OECD countries entered into a new ASU (the “**2007 ASU**”) which replaced the previous ASU which had been agreed to in 1986<sup>1116</sup>. The main reason for having the 2007 ASU was that industry participants had long required the 1986 Large Aircraft Sector Understanding to be extended to cover also regional jet-producing countries and therefore be applicable for all civil aircraft (particularly as the distinction between large aircraft and regional jets became increasingly blurred)<sup>1117</sup>. Furthermore, it had been felt that the 1986 Large Aircraft Sector Understanding did not have adequate exchange of information possibilities amongst ECAs in place and did not produce reliable data regarding the financing of exports<sup>1118</sup>.

The 2007 ASU was further revised in September 2011 and replaced by a new Aircraft Sector Understanding (the “**2011 ASU**”<sup>1119</sup>) particularly in light of a number of disputes which had arisen as to the role ECAs should play (particularly in light of the increased use thereof following the global financial crisis)<sup>1120</sup>. The 2011 ASU therefore sought to bring ECA financing in line with market conditions, and minimise the support of ECAs as a factor in the choice by buyers (which would be obtaining finance from ECAs) among competing aircraft<sup>1121</sup>. In light of the problems faced by the 2007 ASU, the 2011 ASU did

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<sup>1115</sup> Gerber (n 1110) 14.

<sup>1116</sup> Chan (n 1109) 511; 2007 ASU (n 1109) 2.

<sup>1117</sup> Gerber (n 1110) 14; Friedenzohn (n 1111) 1.

<sup>1118</sup> Gerber (n 1110) 14.

<sup>1119</sup> The 2011 ASU has been subject to further minor reviews from time to time with the latest revision having been published on 15 October 2015 and which takes effect as from the 17<sup>th</sup> September 2015. Reference to the “*2011 ASU*” means a reference to the 2011 Aircraft Sector Understanding as amended by and until the 17<sup>th</sup> September 2015; 2015 Export Credits Arrangement (n 1109).

<sup>1120</sup> Gerber (n 1110) 1, 14 - 15; The main disputes in the 2007 ASU related to the categorisation of aircraft as new aircraft models were developed, as well as in light of the “*Home-Country Rule*” which had been adopted in relation to financing of aircraft as from 1992 (in virtue of which the so-called “*Large Aircraft Countries*” did not provide financing for competing aircraft that will be principally located in their own or in each other’s countries, and which started being seen as problematic as marketing conditions started changing in 2008, as ECA financing for a variety of non-home-country airlines proliferated, and as the classification as to what constituted “*large aircraft*” became blurred; Aviation Working Group (n 1114) 3.

<sup>1121</sup> Gerber (n 1110) 15.



not distinguish between different aircraft categories and the types of financing which would be applicable to such categories<sup>1122</sup>.

The 2011 ASU instead placed further emphasis on the risk profile of borrowers and requires them to be classified into one of eight criteria depending on their senior unsecured credit ratings<sup>1123</sup>. Limits were placed on the amount of financing which will be made available to the highest rated borrowers, as the 2011 ASU sought to make ECA financing less desirable for those borrowers which can more readily access the commercial markets for financing<sup>1124</sup>. Furthermore, depending on the risk associated with a borrower, ECAs will be required to include risk mitigants (i.e. the greater number of risk mitigants being required for the riskier borrowers)<sup>1125</sup>. The 2011 ASU also set out that ECA financings are to be structured as eligible asset-backed transactions, outlining the specific components which such financings are to have, with restrictions also being set out on the maximum repayment terms<sup>1126</sup>.

The novelty of the 2007 ASU was that it sought to crystallize incentives which had started being offered by the U.S. Export-Import Bank in relation to the CTC and the Aircraft Protocol<sup>1127</sup>. The U.S. Export-Import Bank had announced that foreign buyers of large aircraft which were situated in a country that signed, ratified and implemented the CTC and the Aircraft Protocol, and provided that a set of declarations were made by that state, would qualify for a one third discount in fees for credit insurance on financings of US manufactured commercial aircraft<sup>1128</sup>.

Therefore, in recognition of the reduction of risk available as a result of the CTC and the Aircraft Protocol, the 2007 ASU put in place a discount (the “**CTC Discounts**” or the “**Cape Town Discounts**”) from the “*base premium*” offered by the ECA, if the operator of an aircraft is based in a contracting state to the CTC and Aircraft Protocol<sup>1129</sup>. The CTC Discounts available under the 2007 ASU varied depending on the categorisation of the particular aircraft<sup>1130</sup>.

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<sup>1122</sup> *ibid*; Friedenzohn (n 1111) 4 – 5.

<sup>1123</sup> Gerber (n 1110) 15.

<sup>1124</sup> *ibid*.

<sup>1125</sup> *ibid* 15 – 16.

<sup>1126</sup> *ibid* 16.

<sup>1127</sup> Goode (n 1039) 192; Aviation Working Group (n 1114) 4.

<sup>1128</sup> Goode (n 1039) 192; van Zwieten (n 1041) 72.

<sup>1129</sup> Chan (n 1109) 512.

<sup>1130</sup> Aviation Working Group (n 1114) 4.

Similarly, the 2011 ASU requires that ECAs charge borrowers a “*minimum premium rate*” (“**MPR**”) which is calculated as a percentage of the amount of official support provided by the ECA, and which is either paid upfront or alternatively over the life of the financing provided (on a 12-year repayment term)<sup>1131</sup>. This MPR varies depending on the risk associated with the borrower through the use of an equation which takes into consideration: the minimum risk-based rates, set annually using a four-year moving average of the annual Moody’s “Loss Given Default”; and a market reflective surcharge which reflects the market conditions and which is based on Moody’s “*Median Credit Spreads*”<sup>1132</sup>. This equation therefore seeks to balance ECA pricing with commercial market pricing<sup>1133</sup>.

The Cape Town Discounts are applicable on the MPR and allow for up to a ten percent (10%) reduction in the MPR if the following conditions are complied with<sup>1134</sup>:

- (1) the financing provided relates to an “*aircraft object*” as defined in the CTC;
- (2) the operator of the aircraft is situated in a jurisdiction that has been reviewed by the OECD and which therefore appears on a list of states for which a reduction in the MPR is permitted;
- (3) the financing provided relates to an aircraft object that has been registered on the CTC International Registry.

These discounts are therefore only available if the contracting state would have made a number of declarations (the “*qualifying declarations*”) which are found in Annex I to Appendix II to the 2011 ASU (particularly in relation to insolvency and to the de-registration and export of aircraft) and if that particular contracting state would have been reviewed by the OECD (following the completion of a questionnaire set out in Annex 2 to Appendix II to the 2011 ASU which reviews the way in which the CTC would have been implemented in the said contracting state)<sup>1135</sup>. The OECD review is necessary in order to ensure that the contracting state has adopted the pro-creditor Alternative A

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<sup>1131</sup> Gerber (n 1110) 16; 2011 ASU (n 1109) 8; Goode (n 1045) 167; 2015 Export Credits Arrangement (n 1109) 54.

<sup>1132</sup> Gerber (n 1110) 16; 2011 ASU (n 1109) 8, 22 – 36; 2015 Export Credits Arrangement (n 1109) 69 – 83.

<sup>1133</sup> Gerber (n 1110) 16.

<sup>1134</sup> *ibid*; van Zwieten (n 1041) 72; Rodríguez de las Heras Ballell (n 1059) 9; Wool 2012 (n 5) 648; 2015 Export Credits Arrangement (n 1109) 77.

<sup>1135</sup> Chan (n 1109) 512; Lippé (n 1063) 87; 2011 ASU (n 1109) 35 – 38; Gerber (n 1110) 16; van Zwieten (n 1041) 72; Rodríguez de las Heras Ballell (n 1059) 9; Wool 2012 (n 5) 645; 2015 Export Credits Arrangement (n 1109) 82 – 85.

put forward by the CTC and its Aircraft Protocol (and as a result of which such state would be listed on a list of states to which the CTC Discounts would apply)<sup>1136</sup>. Therefore the CTC Discounts are available “*if, and only if, the qualifying declarations are made*”, and this in light of the fact that “[c]ertain declarations result in risk reduction, and others do not”<sup>1137</sup>. As a result, markets view the qualifying declarations as a condition in order for there to be the most efficient forms of financing available<sup>1138</sup>.

The qualifying declarations to qualify for the CTC Discounts require a contracting state to have opted for the Alternative A option for remedies on insolvency (or alternatively have introduced legislation which precisely follows the Alternative A wording), as this gives the greatest protection to creditors<sup>1139</sup>. Other declarations required in order to qualify for CTC Discounts include that of allowing for the de-registration of aircraft in accordance with Article XIII of the Aircraft Protocol, as well as a declaration to ensure timely remedies<sup>1140</sup>. Contracting states also need to have not made other restrictive declarations in order for the CTC Discounts to apply<sup>1141</sup>.

#### ***8.4 Impact of the CTC on Capital Market Transactions***

Other than the Cape Town Discounts referred to above, the CTC and the Aircraft Protocol have also been given due consideration in the rating of debt securities supported by aircraft equipment collateral<sup>1142</sup>. On rating equipment trust certificates and enhanced equipment trust certificates (which are primarily used for the financing of railroad and of airline equipment), consideration is also given, by rating agencies, to the impact of the CTC<sup>1143</sup>.

Therefore, though the Fitch rating methodology for enhanced equipment trust certificates in aircraft finance focuses primarily on US-issued certificates, it suggests that non-US issues would be evaluated on a “*case-by-case basis, focusing in particular on the relative strength of the legal framework in the country of issue*”, and that the US-issue rating methodology could be applied where the said issue jurisdiction has “*an insolvency*

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<sup>1136</sup> Chan (n 1109) 512; Lippé (n 1063) 87; 2011 ASU (n 1109) 35 – 38; Gerber (n 1110) 16; van Zwieten (n 1041) 72; Rodríguez de las Heras Ballell (n 1059) 9; 2015 Export Credits Arrangement (n 1109) 82 – 85.

<sup>1137</sup> Wool 2012 (n 5) 645.

<sup>1138</sup> *ibid.*

<sup>1139</sup> Goode (n 1039) 193.

<sup>1140</sup> 2011 ASU (n 1109) 35 – 36; Rodríguez de las Heras Ballell (n 1059) 9; 2015 Export Credits Arrangement (n 1109) 82 – 83.

<sup>1141</sup> 2011 ASU (n 1109) 35 – 36; 2015 Export Credits Arrangement (n 1109) 82 – 83.

<sup>1142</sup> van Zwieten (n 1041) 73.

<sup>1143</sup> *ibid*; Reddy, Vairo and Hewitt (n 1102) 237; Goode (n 1045) 167.

*regime similar to Section 1110<sup>1144</sup> which allows creditors to repossess aircraft in a timely fashion”<sup>1145</sup>. It continues by stating that the CTC could supply such a legal framework if this is adopted in the appropriate form (by having adopted the Alternative A to insolvency seen above, and which is the equivalent to the said Section 1110 of the US Bankruptcy Code), and if the CTC would have been properly implemented<sup>1146</sup>.*

Similarly Moody’s ratings of equipment trust certificates and of enhanced equipment trust certificates in aircraft and railroad finance provides for ratings to be uplifted by up to two notches where the home country of a debtor is a contracting state to the CTC and to the Aircraft Protocol<sup>1147</sup>. However both Fitch and Moody’s have in the past noted that the lack of case-law in different jurisdictions may lead to these rating agencies only partially adopting these measures or applying them only subjectively<sup>1148</sup>.

The economic effect should thus be that market pricing should be cheaper for securities rated by credit rating agencies, as a result of the adoption of the CTC and the Aircraft Protocol.

### ***8.5 Impact of the CTC on the provision of debt by banks***

It has been stated that the presence of the CTC, coupled with the qualifying declarations and proper implementation, has led at least one major financial regulator to permit a *“reduction in the amount of risk capital held by a regulated lender”<sup>1149</sup>*. Though details of this are not available, this reduction has taken place in light of the particular bank’s overall risk assessment model (i.e. through the adoption of the Advanced IRB method under the Basel Accords)<sup>1150</sup>. The possible positive effects on the provision of debt by banks, has also been recognised by the Official Commentary to the CTC which stated that<sup>1151</sup>:

*[a]doption of the Cape Town Convention and Aircraft Protocol, by reducing risk and enhancing the value of aircraft objects and receivables provided as collateral, may also enable creditor banks to reduce the amount of capital required to be*

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<sup>1144</sup> 11 USC S 1110 (US Bankruptcy Code).

<sup>1145</sup> van Zwieten (n 1041) 73.

<sup>1146</sup> *ibid*.

<sup>1147</sup> *ibid*; Wool 2012 (n 5) 648 – 649.

<sup>1148</sup> van Zwieten (n 1041) 73.

<sup>1149</sup> Wool 2012 (n 5) 649.

<sup>1150</sup> *ibid*.

<sup>1151</sup> Goode (n 1045) 167.

*maintained under Basel III because of the enhanced value of aircraft receivables collateral.*

The same principles are also adopted in the criteria established by the Basel Accords (and currently being under consideration by the EBA, following its consultation paper<sup>1152</sup>) when establishing the criteria for the “*supervisory slotting criteria approach*”<sup>1153</sup>. On establishing the said supervisory slotting approach criteria reference is made, as criteria to be considered amongst various other matters (in object finance) to both<sup>1154</sup>:

- legal and regulatory risks (particularly whether a jurisdiction is favourable to repossession and enforcement of contracts); and
- whether legal documentation provides the lender effective control (i.e. a first perfected security interest, or a leasing structure including such security) on the asset, or on the company owning it.

## ***8.6 Other impacts of the CTC***

It has also been recognised that certain lessors require the availability of the CTC (in the country of operation of the lessee or where the aircraft will be habitually situate) as a pre-condition to the leasing of aircraft (or of leasing aircraft in larger volumes)<sup>1155</sup>. The CTC is also viewed favourably by credit committees generally, given that it works towards directly reducing transaction risk<sup>1156</sup>.

It is therefore acknowledged that the adoption of the CTC has given certainty to creditors and lessors by ensuring them that the aircraft will be subject pro-creditor laws, thereby giving them certainty that harmonised concepts relating to insolvency and international interests apply for their benefit.

## ***8.7 The CTC as a Model for the Basel Accords***

As seen throughout this Chapter, the drafters of the Basel Accords and the drafters of the CTC and the Aircraft Protocol were faced with a number of similar questions and problems. It is here argued that the adoption of a law and economics approach by the drafters of the CTC, the use of a Treaty which creates binding obligations between states,

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<sup>1152</sup> European Banking Authority (n 994).

<sup>1153</sup> See: Basel II (n 264) Annex 6.

<sup>1154</sup> Basel II (n 264) Annex 6, 291 – 294.

<sup>1155</sup> Wool 2012 (n 5) 649.

<sup>1156</sup> *ibid.*

and the ability to deal with varying underlying national laws on insolvency and security interests, represent fundamental differences in the approach taken by the drafters of the Basel Accords, and the drafters of the CTC and the Aircraft Protocol respectively.

Consequently it is argued that the issues raised by this thesis in relation to the Basel Accords could be overcome by adopting positions which reflect the positions taken by the drafters of the CTC and the Aircraft Protocol throughout the years. It is for this reason that it is contended that the latter approach should be used as a model by the drafters of the Basel Accords in order to overcome the issues raised throughout this thesis.

## Chapter 9: Proposals and Concluding Remarks

### 9.1 *Problems Outlined by the Thesis*

This thesis has argued that the main factor which has impeded the Basel Accords from reaching its objectives, is that the promoters of the Basel Accords have failed to consider the separate interests which each of the international community, the individual nation states, and the industry have. Each of these players give strong considerations to their own self-interest on negotiating, implementing, and enforcing the Basel Accords.

This thesis has also highlighted the lack of regulatory consistency in the Basel Accords, as a result of a lack of harmonisation or effective cooperation amongst states in order to determine the entities to which the Basel Accords should apply. This has enabled the industry to resort to regulatory arbitrage, by making use of entities which fall outside of the scope of the Basel Accords, as well as by having those same entities operating through more favourable jurisdictions as a result of the varying approaches which different states have adopted on implementing the Basel Accords.

The Basel Accords further fail to consider the domestic embeddedness within which the implementing laws in different jurisdictions are meant to operate, with this thesis making particular mention of the varying laws on security interests and insolvency in different jurisdictions. Though the Basel Accords seek to regulate the risk of internationally-active banks, the Basel Accords fail to consider that the risks arising in one jurisdiction are not equivalent to the risks arising in another jurisdiction notwithstanding that similar transnational regulatory laws apply. Furthermore, it is also argued that in light of the lack of proper consideration of risk mitigating factors (such as collateral provided on a transactional basis), certain transactions which may be considered to be “*low risk*” transactions to banks (in light of the collateral provided), may be considered to be very risky by the Basel Accords (in light of the limitations in what is considered to be “*eligible collateral*” under the Basel Accords), with this resulting in a mismatch between the risk management techniques adopted by the Basel Accords on a macroeconomic level, and by those adopted by banks on a microeconomic (transactional) level.

Reference has been made to the CTC in Chapter 8 since this transnational law instrument has been able to deal with each of the problems which the Basel Accords faces, as discussed above. It is therefore here argued that the same methodology

adopted in the CTC should similarly be adopted in transnational regulatory instruments such as the Basel Accords.

This thesis argues that in order to be able to increase the effectiveness of the Basel Accords it is desirable to move away from having only a “*soft-law*” approach as has been adopted by the Basel Accords, whilst allowing for further flexibility in the implementation of the Basel Accords, notwithstanding that this may give rise to further regulatory competition amongst jurisdictions. It is thus also argued that the Basel Accords can be used as a tool through which to achieve further harmonisation in the laws of insolvency and security interests by adopting the same approach which has been adopted by the CTC.

## **9.2 Recommendations**

### **9.2.1 Introducing Binding Principles to the Basel Accords**

As abovementioned, the Basel Accords have made use of transnational regulatory laws which are “*soft-laws*” in nature, and this thesis has also described various problems which have arisen as a consequence of this. It is therefore here being proposed to move away from a “*soft-law*” approach towards the use of a Treaty (based on a transnational law, rather than on a transnational regulatory law), which will create binding rights and obligations between its signatories. This will ensure that states comply with established principles and achieve uniformity on those same principles.

Brummer (though advocating the use of soft-law) notes that though theorists generally assume that hard law coordination is more difficult, this is “*ultimately more durable*” given that having “*legalization is seen as imposing reputational harms that soft law cannot*”, particularly since defections from hard laws are considered to be violations of international law<sup>1157</sup>.

Given that it would be improbable for there to be full harmonisation across borders, it is here proposed that a Treaty establishing the main principles on which the Basel Accords are based, to which entities they should apply, and possible incentives to states to work towards harmonising their laws on security interests and insolvency should be dealt with at Treaty level, whilst allowing the detailed rules which are currently regulated by the current texts of the Basel Accords to continue to be dealt with through soft-law methods in the same way as they are today. This thesis therefore proposes that the

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<sup>1157</sup> Brummer (n 100) 305.



binding text at Treaty level will only seek to achieve harmonisation on the main principles on which the Basel Accords are based.

One of the main items which should be considered in such a Treaty would be to specifically define which entities are meant to be regulated by the provisions of the Basel Accords. As seen throughout this thesis the identification of “*internationally-active banks*” as being the subjects of the Basel Accords is not sufficient. A proper definition needs to look beyond the regulatory boundary and ensure that the same principles apply in different jurisdictions. This Treaty should also be wary that the industry has historically aimed to shift its activities to other entities which do not fall within the scope of regulation (such as through a shift in activity towards shadow banks).

Whether such a definition will be wide in scope in order to capture entities which are not just “*internationally-active*”, or even “*systemically-important*”, will depend on what role the Basel Accords are meant to play in the years to come. As seen throughout this thesis the Basel Accords originally set out to regulate cross-border activities of banks only. The implementing laws throughout various jurisdictions (including the EU), have however, extended the Basel Accords in order for these to provide a standard for all banks (and also other entities such as investment firms). Therefore, whether an international Treaty would extend to regulate all banks or just banks which are considered to be systemically important will depend on a decision as to what role the BCBS considers that the Basel Accords should fulfil going forward. This thesis has however shown how the Basel Accords are already considered to be a global standard across jurisdictions (despite being subject to many variances) and, therefore, binding principles which would have much less detail than what is in place today, and which would be used to regulate all banks (and possibly other entities), should not be an impossible task.

The approach of having an international Treaty has also been put forward by Helleiner who stated that the “*idea of creating an international treaty-based organization with considerable powers to enforce international hard law*” continues to be “*off the official agenda*”, a number of analysts think that this “*is a shame*” as this may be the only way to ensure concordance<sup>1158</sup>.

Furthermore, whilst states should adhere to the main principles on which the Basel Accords are based (and which are being proposed to be included in a Treaty of a binding

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<sup>1158</sup> Helleiner (n 259) 252 – 253.

nature), it is below argued that regulatory competition should be encouraged in relation to the soft-laws which are meant to be implemented by the different states. This will allow states to seek economically efficient systems of regulation, and allow states to be flexible and pro-active in regulating those entities which are regulated within their jurisdictions.

The approach of having only frameworks agreed to by all states and relying on different national laws also finds resonance with suggestions which had been put forward at an earlier stage in EU integration, whereby it had been argued<sup>1159</sup>:

*The integration solution will not, however, be reached easily if – as was the case until recently – the unanimous consent of all national governments is required before the Community instrument can be issued. Each government will be tempted to hold out for a form of regulation which will minimize any loss to its electorate, perhaps by creating escape clauses and loopholes under which some discretion on the implementation of the regulation is retained. An alternative, and less ambitious, bargaining compromise is possible. If governments wish to preserve the political advantages of domestic regulation and yet also pursue the gains to be made from intra-Community trade, they may be able to agree on what we shall refer to as ‘co-ordination’. This solution takes the form of framework regulation at Community level which does nothing more than state broad policy goals. A Member State may retain its own regulatory packages to implement those goals, but, for the purposes of intra-Community trade, it must recognise that compliance with the regulatory requirements of another Member State will also suffice.*

### **9.2.2 Regulatory Competition as an Alternative to Regulatory Cooperation**

It has been argued that the establishment of transnational regulatory standards by the Basel Accords inhibits regulatory competition, thus hindering efficient regulation<sup>1160</sup>. Harmonization through international standards renders regulation inflexible and results in a situation where regulation cannot be responsive to market changes<sup>1161</sup>. This particularly arises in light of peer pressure which states may be subject to, whereby the international community seeks to ensure that all states adhere to the agreed texts of the Basel Accords. On the other hand, states which exert peer pressure on others may also willingly departing from the agreed texts of the Basel Accords where this suits them.

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<sup>1159</sup> Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing, 2004) 101 – 102.

<sup>1160</sup> Barr and Miller (n 112) 20.

<sup>1161</sup> *ibid.*

The main problem with transnational regulatory laws such as the Basel Accords is that there is no binding rule which creates obligations on states to implement and enforce the particular transnational regulatory law (as soft-law) and states have incentives to depart from the agreed texts of the Basel Accords on acting out of self-interest. It is here argued that in light of the different requirements of each state, adopting a system which relies more heavily on regulatory competition is desirable. This can be achieved if main principles are set out as a transnational law with binding effect (through the use of a Treaty), rather than as a transnational regulatory law, as described in Section 9.2.1.

It is thus argued that though regulatory competition in relation to soft-laws would be desirable, certain fundamental principles should be agreed to in the Treaty which would set out the limits to regulatory competition, thereby avoiding a race to the bottom.

Though having different states adopt different rules through a regulatory competitive process may result in the use of regulatory arbitrage, it is here argued that one cannot discard regulatory competition solely due to this reason. Regulatory arbitrage is already a major problem in relation to the Basel Accords, both due to differences in the laws of different jurisdictions, as well as due to the different financing entities and financial instruments which are made use of. It is furthermore also argued that regulatory arbitrage is not necessarily a negative consideration if this is adopted in order to avoid unnecessary social costs and if it encourages shifts to more efficient or more desirable systems.

The main benefit of this approach is that domestic regulatory authorities would be required to observe the broad principles which could be established internationally (through a Treaty), but be able to adjust and improve on the regulatory principles according to the particular needs of a state, the nature of the firms found in that particular state, and according to the particular laws of that state.

### **9.2.3 Using the Basel Accords to Prompt Harmonisation of Laws on Security Interests and Insolvency**

Another proposal put forward by this thesis is that transnational regulatory laws such as the Basel Accords (and the adoption of binding transnational law instruments as described above) can be used as a means to prompt harmonisation of insolvency laws and laws on security interests. This will ensure that financing entities established and operating in different jurisdictions are subject to the same risks. This will be beneficial since any approximation of laws on security interests and insolvency will allow texts such as the Basel Accords to have the same effects wherever they are implemented,

rather than having one transnational regulatory law which may give rise to different effects depending on the underlying laws of each individual jurisdiction (particularly depending on whether a jurisdiction adopts a pro-creditor or a pro-debtor approach to laws).

It is therefore here proposed to use a system which would be applied in a similar way to that adopted by the CTC. The CTC and its Aircraft Protocol set out two model laws for states ratifying the said Convention (and the Aircraft Protocol) to adopt, with one alternative being a pro-creditor model law, and the second alternative being a pro-debtor model law. Entities operating in jurisdictions which adopt the pro-creditor model law are put at an advantage over entities operating in other jurisdictions, as ECAs give “discounts” to these entities when financing assets acquired by the said entities (in light of the lower legal risks which the ECAs providing finance will be subject).

It is here argued that it is desirable for there to be further harmonisation in the laws on security interests and on insolvency of different jurisdictions, as this will mean that entities operating in different jurisdictions will start being subject to similar legal risks, and with this therefore allowing easier harmonisation of financial regulation and transnational regulatory laws (such as the Basel Accords), whilst allowing these laws to have similar effects across different jurisdictions.

The Basel Accords should therefore be supplemented by model pro-creditor insolvency laws and laws on security interest and should give incentives to jurisdictions to adopt these model laws. Having pro-creditor laws being adopted would mean that financing entities which the Basel Accords seek to regulate will be subject to less risks in light of having better rights of repossession and enforcement of collateral which would have been provided in their favour. Incentives can be provided by having financing entities being entitled to hold less capital in relation to assets being financed, when such assets would be located in jurisdictions which would have adopted the pro-creditor model laws on insolvency and security interests.

This will mean that the Basel Accords will start distinguishing between those jurisdictions which would have adopted a pro-creditor model law and those which would not have done so. The end result will be that banks and financing entities which are subject to less risks (in light of the pro-creditor laws within which they operate), will be required to hold less regulatory capital. This will also mean that once financing entities operate in jurisdictions which are subject to higher risks, then higher levels of capital would need to be maintained.

### **9.3 Concluding Remarks**

This thesis has highlighted a number of problems in the way the Basel Accords has been drafted, and in the way this is implemented and enforced. Most of these problems arising due to a lack of consideration of the different interests which the various actors have in its promulgation, and due to there being a lack of proper legal analysis of the different laws within which the Basel Accords are meant to operate. It is here argued that these problems have primarily arisen due to the Basel Accords being used for a much wider purpose than was originally envisaged, such that whilst the Basel Accords only contemplate the regulation of “*internationally-active banks*”, the Basel Accords have become the regulatory standard through which most banking and financing entities are regulated around the world.

This concluding Chapter has therefore sought to put forward three different proposals through which, it is argued, the main problems highlighted throughout this thesis can be rectified. These proposals are further supported by the successful adoption of the CTC which was intended to deal with similar problems to those which the Basel Accords are subject.

Notwithstanding that the proposals which have been put forward seek to solve the problems which have been raised by this thesis, one needs to keep in mind that these proposals will also need to be analysed from an economic perspective as well as from a banking and finance perspective. Further, empirical research may be helpful in order to show more accurately that the proposed solutions will, in practice, give rise to net positive outcomes.

It is also appreciated that the reforms which have been proposed would give rise to fundamental changes to the system of banking regulation and that it might therefore be challenging to implement these reforms in the short to medium term. Nevertheless, a proper appreciation of the problems which have been highlighted by this thesis should make the drafters of the Basel Accords aware of a number of issues which have been overlooked for too long and to which they should give proper consideration going forward in order to increase the effectiveness of the Basel Accords.

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